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THE INTERNATIONALIZATION OF CAPITAL MARKETS

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

THE IMPLICATIONS OF THE INCREASING SIZE OF THE EUROBOND MARKET, THE INTERNATIONALIZATION OF THE EQUITIES AND MORTGAGE FINANCE MARKETS AND THE INTERNATIONAL ROLE IN COMPETITIVENESS OF U.S. FINANCIAL INSTITUTIONS AND THE EFFECT OF LIBERALIZED REGULATORY SCHEMES IN OTHER COUNTRIES, PARTICULARY IN THE UNITED KINGDOM

FEBRUARY 26, 27, 1986

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THE INTERNATIONALIZATION OF CAPITAL MARKETS

WEDNESDAY, FEBRUARY 26, 1986

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The Chairman. The Banking Committee will come to order.

Today the full Committee on Banking, Housing, and Urban Affairs begins the first of 2 days of oversight hearings on the internationalization of capital markets. These hearings will provide an overview to committee members from private sector participants of the nature and magnitude of the trend toward internationalization. The hearings will address some of the resulting benefits and costs for U.S. participants. They are not intended to explore in detail all of the many issues involved in this broad area.

The committee or various subcommittees may decide later to hold additional hearings to focus more specifically on some of the issues that arise.

Among the issues the hearings will address are the implications of the increasing size of the Eurobond market which last year was larger than the United States corporate debt market; the internationalization of the equities and mortgage finance markets; the international role and competitiveness of United States financial institutions; and the effect of liberalized regulatory schemes in other countries, particularly in the United Kingdom.

The testimony in these hearings will show that internationalization is accelerating and affecting virtually every aspect of the banking and securities industry. It is, therefore, important for this committee to stay abreast of the developments in these markets and recognize their impact on any legislation this committee considers.

Today's hearing consists of two panels. The first panel includes four witnesses who will address the internationalization issues from the U.S. perspective with representatives from a U.S commercial bank, U.S. investment bank, the New York Stock Exchange, and the National Association of Securities Dealers.

The second panel parallels the first by addressing issues from the perspective of a British bank, British merchant bank, and the London Stock Exchange.

Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Thank you, Mr. Chairman.

Mr. Chairman, the internationalization of the world capital markets is here to to stay and the trend toward global trading and global markets is growing and growing at a rapid pace.

About 1½ years ago, the Chairman of the Securities and Exchange Commission asked me whether there were any important areas where I felt the Commission should be devoting more attention. In my written response, dated October 23, 1984, I said the following:

> I am more convinced than ever that an irreversible trend is underway as the result of telecommunications technology. It will accelerate the trading of stocks and other instruments internationally.

I suggested the the Commission begin to plan for the world trading system of the future so as to ensure U.S. involvement and leadership in that system in an ever increasingly competitive international arena.

More specifically, I suggested that the Commission look into the following areas:

First, the effects on trading practices of technological developments, including automation, computerization, and advances in communications technology.

Second, the possible design and development of a worldwide contemporaneous hearing and settlement system, which is an absolutely essential ingredient to effect internationalization of the capital markets.

Third, the transition from national trading systems to global trading systems, particularly in relation to the role in appropriate regulation of U.S. participants.

Fourth, surveillance of global securities trading and the need for cooperative international oversight systems, exchanges of information and international enforcement cooperation.

Fifth, procedures for listing, disclosure, and distribution of securities, particularly in relation to multinational and international issues of securities.

Also, sixth, institutional mechanisms for international cooperation in regulating securities and related transactions, particularly in relation to the appropriate role of U.S. regulatory bodies, self-regulatory organizations, and private entities in the emerging global system.

The Commission has begun the task of looking into these issues, and I would encourage them to continue and expand their efforts.

Mr. Chairman, I think the mere fact that you are holding hearings on these subjects today and tomorrow is extremely important in focusing the attention of both our private and our governmental sector to these vital issues.

I have no preconception as to what the appropriate governmental or private sector response ought to be to the issues I have mentioned.

I do know that if we do not take the lead in addressing these subjects, the world will not wait for us, and as sure as the day is long, others will take advantage of competitive opportunities, develop regulatory and national structures which will capture increasingly more of the international capital markets at our expense.

I believe that we, as well as our allies, are best served by working cooperatively to develop and harmonize, insofar as possible, our international markets. Through such cooperation, but with the United States leading the way, I believe our global markets will become more efficient, the world will become more interdependent and the cause of capitalism will be further served.

The benefits of developing a more integrated international capital market system would be immeasurable.

Mr. Chairman, I ask that my letter to SEC Chairman Shad, dated October 23, 1984, as well as the Commission's release on the subject, dated April 25, 1985, the Commission's summary of comments in that release, be made part of the record. Thank you.

The CHAIRMAN. Without objection, so ordered.

[Senator Proxmire's letter to SEC Chairman Shad and the SEC release dated April 25, 1985, along with the complete prepared statement of Senator Proxmire follow:]

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, October 23, 1984.

Hon. JOHN S.R. SHAD,
Chairman, Securities and Exchange Commission,
Washington, DC.

DEAR MR. CHAIRMAN: In your letter dated September 27, 1984 you asked me whether there are any important areas I feel the SEC should address during the coming year.

My first reaction is the obvious one that the Commission should continue to plug away and aggressively place a primary emphasis on investor protection, full and fair disclosure, orderly markets, and rigorous enforcement of the securities laws so as to ensure, as you put it in your Harvard Business School Club speech, October 2, 1984 that the United States continues to have "the best securities markets the world has ever known—the broadest, the most active and efficient—and the fairest." These are basic prerequisites to such a market which should not be overlooked in the pursuit of new activities.

I am also struck by a number of the issues that are raised in the SEC's publication of its Major Issues Conference, June 28–29, 1984. Among those that certainly deserve continued and focused attention include the increased institutionalization of the securities markets with its concomitant increase in reliance upon market professionals and how this effects the individual investor and his or her confidence in the markets and our capital raising mechanisms; the harmonizing of regulations in the financial services industries so as to create a sense of competitive fairness among depository and nondepository financial institutions; the integrity, desirability, and regulation of new products; exchange listing requirements; and disclosure requirements for municipal issuers, especially with respect to industrial revenue bonds.

But another issue is being brought to my attention with increasing frequency and urgency which I believe also requires immediate attention plus long-range planning on the part of the Commission. This issue, which has been recognized by the Commission, involves the internationalization of the securities markets and the rapidly evolving global nature of our world trading system—in other words, planning for the world trading system of the future and United States involvement and leadership in that system in an ever increasingly competitive international arena.

I am more convinced than ever that an irreversible trend is underway as a result of telecommunications technology in this information age that will accelerate the trading of stocks and other instruments internationally.

It is already possible to identify over 200 stocks that are regularly bought and sold outside of their country of origin and all signs appear to be pointing toward more. A number of responsible commentators suggest that a world trading system is currently in the process of being, and will in the foreseeable future be, created. The result, according to some, will be that this new market will take many of the most attractive securities off the floors of national stock exchanges and draw them into an entirely different arena, and that as this process takes place, traditional structures will come tumbling down. What is projected by some is a fight for control of the benefits that will flow from this international market as British, Japanese, American, and other nations' securities firms wrestle to become the dominant market-makers and information purveyors in the new system.

It has been suggested to me that it is time to begin viewing exchanges more as communications and information systems than as trading systems and to begin to prepare for the heightened competition between nations for control of this international communications and trading network which many project will ultimately take place in a telephone market away from the floor of any exchange and without the charging of any commission.

It has also been suggested to me that now is the time to think about the establishment of a domestic advisory committee followed by an international committee, under American leadership, to plan for the global trading system of the future.

In 1983 the Commission, under your leadership, established a Tender Offer Advisory Panel to make recommendations for changes in our laws and regulations regarding change of control situations.

I believe that consideration must now be given to the formation of a new broadly constituted Advisory Committee on Trading Systems. This Committee would, among other things, consider the following topics:

(1) Automation and current trading practices.

(2) Developments in communications and computer technology and their effects on off-the-floor trading.

(3) The move from national trading systems to global trading systems and the role and appropriate regulation of United States participants.

(4) The shift of domestic pension assets into non-American securities.

(5) The preservation and creation of quality domestic/international trading systems.

(6) Surveillance systems in a global trading system and the need for cooperative international oversight systems, exchanges of information, and greater international enforcement cooperation.

(7) Listing and disclosure requirements.

(8) Appropriate regulation of distributions of securities which may be issued in different countries.

(9) Design of a world-wide contemporaneous clearing and settlements system.

(10) The future role of the SEC in a world trading system.

(11) The formalization of adequate institutional mechanisms for international cooperation and the appropriate role of the United States in developing and interacting with other countries in the emerging global trading system.

These are obviously very general suggestions dealing with an extraordinarily complex situation, but they are the thoughts of one Senator who has spent a career overseeing the Securities and Exchange Commission and who is deeply committed to preserving the leadership of the United States in the capital systems of the world.

Since I consider the emerging global trading system to be vital to America's national interest I would be delighted to lend my support to the type of broad-based effort I have recommended.

Sincerely,

William Proxmire.

concert under § 574.4(d) has been rebutted;

(3) With regard to notices filed under § 574.3(b), to acquire control of insured institutions which cannot be approved under paragraph (a) of this section:

(i) All actions regarding publication required or permitted by § 574.6(d).

(ii) Any other action which would otherwise be delegated to the Principal Supervisory Agent pursuant to paragraph (a) of this section.

(c) *Sole authority in the Corporation.* The Corporation alone may:

(1) Approve or deny any applications or notices which are not delegated;

(2) In addition to any other remedies available to the Corporation, assess a civil penalty under paragraph (16) of the Control Act for any person who willfully violates any provision of the Control Act, or any regulation or order issued by the Corporation pursuant thereto, of not more then $10,000 per day for each day during which the violation continues:

(i) By giving written notice of the basis for the violation, the amount of the proposed civil penalty, and an opportunity for the person to submit data, views, and arguments within 20 days; and

(ii) By giving due consideration to the appropriateness of the penalty with respect to each of the factors specified in paragraph (16) of the Control Act, 12 U.S.C. 1730(q)(16), and issuing to the person, within 30 days of the expiration of the period provided to make a submission, a written notice of the Corporation's order of assessment which must be paid within 10 days, unless otherwise agreed to, or the Corporation may bring an action to collect the assessed penalty.

(3) In addition to any other remedies available to the Corporation, assess a civil penalty of not more than $1,000 per day for each day during which the violation continues under section 408(j) of the Holding Company Act, 12 U.S.C. 1730a(j), for any company that violates or any person who participates in a violation of the Holding Company Act or any regulation or order issued pursuant thereto. As used in this paragraph, the term "violates" includes, without limitation, any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding and abetting a violation.

SUBCHAPTER F—SAVINGS AND LOAN HOLDING COMPANIES

PART 584—REGULATED ACTIVITIES

4. Revise § 584.4 as follows:

§ 584.4 Prohibited acquisitions.

No savings and loan holding company, directly or indirectly, or through one or more transactions, shall:

(a) Acquire by purchase or otherwise any of the voting shares of an insured institution not a subsidiary, or of a savings and loan holding company not a subsidiary, or, in the case of a multiple savings and loan holding company, so acquire or retain more than five percent of the voting shares of any company that is not a subsidiary and that is engaged in any business activity other than those specified in paragraphs (b) of § 584.2 or § 584.2-1; or

(b) Acquire control of an uninsured institution or retain, for more than one year after the date any insured institution becomes uninsured, control of such institution.

§ 584.4-1 [Removed]

5. Remove § 584.4-1.

§ 584.10 [Amended]

6. Revise § 584.10 by removing paragraph (d) thereof and redesignating paragraph (e) as (d).

PART 589—BOARD RULINGS

§ 589.1 [Removed]

7. Remove § 589.1.

(Change in Savings and Loan Control Act, 12 U.S.C. 1730(a); Savings and Loan Holding Company Act, 12 U.S.C. 1730a; Section 17(a) of the Federal Home Loan Bank Act, 12 U.S.C. 1437(a); Reorg. Plan No. 3 of 1947, 3 CFR 1071 (1943-48 Comp.))

By the Federal Home Loan Bank Board.

Jeff Sconyers,

Secretary.

[FR Doc. 85-[illegible] Filed 4-24-85; 8:45 am]

BILLING CODE [illegible]

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-21958; File No. S7-16-85]

Request for Comments on Issues Concerning Internationalization of the World Securities Markets

AGENCY: Securities and Exchange Commission.

ACTION: Request for Comments.

SUMMARY: The Commission solicits comment on issues concerning the increasing internationalization of the world's securities markets. In light of the accelerating movement towards global trading markets for certain securities and the increasing flow of investments across national borders, the Commission believes that it now is appropriate to review these developments and to consider ways of attaining the fairest and most efficient global markets possible.

DATES: Comments to be received by June 30, 1985.

ADDRESS: Persons wishing to submit comments should file three copies with John Wheeler, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. All comments should refer to File No. S7-16-85 and will be available for inspection at the Commission's Public Reference Room.

FOR FURTHER INFORMATION CONTACT: Andrew E. Feldman, Esq., (202) 272-2388, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

I. Introduction

A. Background

The Commission is requesting comment on a number of issues concerning the growing internationalization of the securities trading markets.[1] In recent years there has been an increasing tendency for major securities to be traded not only in the capital market of their country of origin, but also in other financial centers around the world. The future direction of this international trading and its implications for existing markets, however, remains largely unknown.

The Commission is publishing this request for comment with the aim of providing a forum for consideration of the issues raised by internationalization and for discussion of the manner in which global trading markets should develop. The Commission believes that forethought and cooperation between the securities industry and national regulatory bodies can help make the evolving global markets more fair, efficient, and accessible.

B. Market Developments

There has been an increasing tendency for securities to become traded internationally. The emergence of the Eurobond market in 1963 was the vanguard of this internationalization process, and debt has continued to be the most prominent element in the international markets. In recent years, the growth in this market has accelerated markedly. Total new issues of Eurobonds rose from $45 billion in 1983 to $180.3 billion in the first 11 months of 1984.[2] United States issuers raised $8.2 billion in Eurobonds in 1983 and $6.8 billion in the first half of 1984.[3] In addition, the United States government [4] and several quasi-governmental entities [5] have made direct offerings to foreign investors totaling over $14.35 billion since the repeal of the withholding tax on interest paid to foreign holders of such debt securities.

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[1] The Commission recently also requested comment on issues regarding the internationalization of the process of public offering of securities. Securities Act Release No. [illegible] (March 1, 1985), 50 FR [illegible] ("Multinational Offerings Release").

At the same time, foreign issuers and investors have increasingly tapped United States capital markets. Nineteen foreign private issuers raised $2.3 billion through debt offerings in the United States in 1983,[6] and foreign government issuers offered $3.1 billion in debt in the United States in 1984.[7]

Although the growth of the Eurobond market and cross-national issuances of debt in recent years have tended to overshadow development in the equities markets, global currents also have begun to touch the equities markets. Eighteen foreign companies (excluding Canadian issuers) raised approximately $1 billion in equity in the United States in 1983.[8] In addition, foreign purchases of United States stocks have increased year by year. Net foreign purchases of United States equities increased from $3.9 billion in 1982 to $5.2 billion in 1983;[9] total transactions by foreign investors in United States equities totaled $134.3 billion in 1983.[10] United States investment in foreign equities has also increased through the years.[11] It has been estimated that United States institutions now hold $10–$13 billion [12] in foreign stocks, compared to $1–2 billion five to ten years ago.[13] Surveys indicate that 19% of United States pension funds invested overseas in 1983, and another 9% were expected to begin in 1984.[14] Many foreign institutions also are investing substantial amounts in other countries.[15]

Several factors have been instrumental in fostering this global investment in equities.[16] In particular, investors have sought to diversify investments across national lines to take advantage of periods in which foreign markets have experienced rates of growth unmatched by domestic markets. This tendency was particularly pronounced during 1984, when the European, Australia, Far East ("EAFE") Index substantially outperformed the United States markets whether measured in local currencies or dollars.[17]

Increased familiarity with multinational companies and a desire to diversify investments globally also has generated interest in international investment among individual investors. Individuals invest both directly in foreign stocks[18] and through internationally-oriented investment companies.[19] Direct investment in foreign stocks has been made considerably simpler for United States investors as a result of the increased listing and trading of foreign stocks (or American Depository Receipts ("ADRs") on foreign stocks) on United States markets. As of the beginning of 1984, 46 foreign securities or ADRs were listed on the New York Stock Exchange ("NYSE"), 52 were listed on the American Stock Exchange ("Amex"), and 294 were quoted in NASDAQ.[20] In 1984, the trading volume of foreign securities and ADRs exceeded 817 million shares on the NYSE, 197 million shares on the Amex, and 908 million shares on NASDAQ.[21]

United States stocks also increasingly are being traded overseas, either through official listings on foreign exchanges or in over-the-counter ("OTC") trading by securities firms. As of January 1, 1985, approximately 200 domestic NYSE-listed companies were listed also on the London Stock Exchange ("LSE"), 43 on the Paris Bourse, and 8 on the Tokyo Stock Exchange.[22] A company may seek a listing on an overseas exchange to obtain greater exposure in that country in the hope of eventually raising capital there.

In addition, OTC trading has been initiated overseas in major stocks to accommodate trading interest in multinational companies among dealers and foreign institutions. An element of this OTC trading has been the development of the ability for broker-dealers to trade continuously around-the-clock by passing their trading positions on to traders located in branch offices in later time zones.

The desire to accommodate international trading interest has motivated the securities markets to consider ways of extending their trading hours, as well as ways of cooperating with other markets through linkages and coordination of market information.[23] For instance, the Boston Stock Exchange ("BSE") and the Montreal Exchange ("ME") currently operate a link between their markets. In the first phase of the linkage, now operational, ME specialists can send orders in a small number of Canadian national issues also listed in the United States for execution by BSE specialists. This provides a means for ME specialists to offer additional markets to Canadian customers and provides the BSE access to an additional source of possible order flow. In subsequent phases, the two markets will connect BSE specialists to the ME's automated small order execution system ("MORRE")[24] and may provide access for United States broker-dealers and investors to the MORRE system.[25] In addition to linkage has been proposed between the Toronto Stock Exchange and the Amex.[26]

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[2] Kristoff, *World Financial Curbs Eased by Technology and Ideology*, New York Times, January 28, 1985, at 1 ("Kristoff").

[3] *The One World Capital Market*, Euromoney, October 1984, at 108. In recent months a Euroyen market also has begun to emerge.

[4] The Treasury has made a $1 billion offering of foreign targeted debt. Based on information obtained from the Treasury.

[5] The Federal National Mortgage Association ("Fannie Mae") and the Student Loan Marketing Association ("Sallie Mae") have made foreign offerings totaling approximately $13.25 billion and $100 million respectively. Based on information obtained from Fannie Mae and Sallie Mae.

[6] Soloman, *An SEC Survival Kit*, Institutional Investor, May 1984, at 119.

[7] SEC Monthly Statistical Review, v. 44 No. 2, February 1985, at 14.

[8] *Investors in the United States are Putting a Damper on Stocks offerings by Foreign Concerns*, Wall Street Journal, November 11, 1984, at 2. Major foreign offerings in the United States in 1983 included offerings by Ericsson, Alcan Aluminum, and Bell Canada. In 1984, Reuters Ltd. offered $310 million and British Telecom offered approximately $4.7 billion in equity simultaneously in the United States and other countries.

[9] SIA *Securities Industry Yearbook 1984–85* 394 (1984).

[10] *Id.*

[11] The pace of foreign investment slowed somewhat in 1984, however. *See U.S. Investors Slash Foreign Portfolios as Domestic Vigor Lures Back Dollars*, Wall Street Journal, February 28, 1985, at 35.

[12] Kristoff, *supra* note 2, at 1; *The Great Deregulation Explosion*, Euromoney, October 1984, at 61.

[13] Kristoff, *supra* note 2, at 1.

[14] *The Rise of the International Explosion*, Euromoney, May 1984, at 84.

[15] *The Great Deregulation Explosion*, Euromoney, October 1984, at 61.

[16] These factors include the recent peace and prosperity of the developed countries, new transportation and communications technology, the advent of floating exchange rates, and the relaxation of foreign exchange controls. *See* Multinational Offerings Release, *supra* note 1, at 8381.

[17] DuBois, *The Year Eight Foreign Markets Outpaced Wall Street*, Barrons January 7, 1985, at 53 (based on Capital International S.A. data). Eight individual foreign markets outperformed the U.S. last year as measured in dollars, while 13 markets outpaced the U.S. as measured in local currencies.

[18] Foreign markets increasingly are being made more accessible to facilitate investment in the securities of such countries. For instance, Sweden and Finland recently established free share registers to allow foreigners to trade more freely in domestic equities.

[19] The number of international and global-oriented investment companies has increased in recent years. By April 1984 there were 18 globally oriented mutual funds (funds that invest both in the United States and overseas), with $6.5 billion in assets. Chesser, *American Money Managers Learn a Lesson*, Institutional Investor (Int. Ed.), April 1984, at 173.

[20] *NYSE 1984 Fact Book*, 40; *Amex 1983 Fact Book*, 10; *NASDAQ 1983 Fact Book*, 80.

[21] Based on information obtained from the NYSE, Amex, and NASD. These figures represent 3.5%, 12.8% and 6.9% respectively of the overall trading volume on these markets.

[22] Based on information obtained from the NYSE. Approximately 600 companies, including both U.S. and foreign companies, have officially listed on overseas stock exchanges. Of these, it has been estimated that 236 multinational companies are actively traded in international markets on a daily basis, of which 84 are United States corporations. *The Corporate List*, Euromoney, May 1984, at 71.

In addition, the NYSE recently has explored the idea of developing some form of twenty-four hour trading mechanism, and it appears to be considering an incremental extension of trading hours in the near future.[27] It also has engaged in discussions concerning a possible merger with the Pacific Stock Exchange ("PSE"), reportedly designed in part to take advantage of the PSE's location in a later time zone.[28] Informal discussions are also reported to have taken place between the NYSE and the LSE concerning coordinated trade reporting systems for dually listed stocks.[29]

Broker-dealers and banks from various countries also have expanded their international securities activities. This has been facilitated by initial steps taken by foreign regulators and markets to reduce restrictions on the involvement of foreign broker-dealers in their markets.[30] For example, as restrictions on foreign ownership of LSE members have been reduced, a number of banks and investment bankers have purchased interests in London brokerage firms with the intent of expanding these interests when greater foreign ownership of LSE member firms is allowed.[31] Foreign banks and investment bankers also have increased their activity in Japan, and one firm recently sought unsuccessfully to become the first foreign member of the Tokyo Stock Exchange.[32] In addition, certain Canadian regulators have signalled a willingness to loosen restrictions on the ability of foreign brokerage firms to register.[33]

Moreover, in the area of securities processing, United States clearing agencies since 1980 have been developing links with foreign clearing agencies to more efficiently and safely process international securities transactions.[34] Typically, the links involve a foreign clearing agency becoming a member of a United States clearing agency and participating on behalf of the foreign clearing agency's members. The foreign clearing agency is liable as principal for the transactions of its members and is subject to the United States clearing agency's rules. For example, the Candian Depository for Securities Limited, a Canadian clearing agency operating in Montreal and Toronto, has become a member of the National Securities Clearing Corporation in New York City.[35] That link processes over-the-counter transactions between United States and Canadian broker-dealers and transactions that occur on the BSE/ME trading floor link. Similarly, the Vancouver Stock Exchange Service Corporation has become a member of the Midwest Clearing Corporation. That link also processes over-the-counter trades between United States and Canadian broker-dealers. Other processing links not involving foreign clearing agency membership in a United States clearing agency have been developed between the Amsterdam Stock Exchange and the Depository Trust Company in New York City,[36] between Trans Canada Options, Inc. and the Options Clearing Corporation in Chicago,[37] and between Trans Canada Options, Inc. and the National Securities Clearing Corporation.[38] Only those links in which the foreign clearing agency has became a member of a United States clearing agency, however, have enjoyed significant use to date.

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[23] Formal links with foreign markets also have been developed or proposed by a number of United States futures exchanges. The most sophisticated linkage to date involves the Chicago Mercantile Exchange and the Singapore International Monetary Exchange. These two markets have implemented a linkage in which fungible Eurodollar and Deutsche mark futures contracts are traded on both exchanges. An international mechanism allows a futures position established on one exchange to be offset on the other exchange. *See* Memorandum from the Division of Trading and Markets and the Division of Economic Analysis to the Commodity Futures Trading Commission, Re Proposed Rules and Rule Amendments of the Chicago Mercantile Exchange Relating to the Establishment of a Proposed Mutual Offset System with the Singapore International Monetary Exchange, Ltd. (August 22, 1984) ("CFTC CME-Simex Memorandum"). A similar link has been proposed by the Commodities Exchange and the Sydney Futures Exchange. *Wall Street Letter*, December 10, 1984, at 4. A number of United States and foreign exchanges also have discussed the possibility of introducing futures on foreign stock indices in the United States. *Wall Street Letter*, February 18, 1985, at 1, 9. In addition, various European exchanges have developed a pilot system to link their market information systems together. *Trading Across Frontiers*, Euromoney, May 1984, at 110.

[24] Securities Exchange Act Release No. 21925 (April 8, 1985). On April 8, 1985, the Commission approved the implementation of Phase II of the linkage, which will, in the summer of 1985, expand the list of securities eligible to trade through the linkage to include approximately 200 limited United States-listed securities available for trading through the Intermarket Trading System ("ITS"). *Id.*

[25] *See* Letter from Michael R. Lindburg, Vice President and General Counsel, BSE, to Richard Chase, Assistant Director, Division of Market Regulation (July 20, 1984).

[26] SR-Amex-85-8. The proposed linkage initially would be limited to trading on a one-way basis between the Toronto Stock Exchange and Amex in a limited number of dually listed stocks, and subsequently would be expanded to a two-way linkage in all dually listed stocks. *Id.*

[27] *Around the Clock Trading in Securities Ahead? Interview with John Phelan, Chairman, New York Stock Exchange*, U.S. News & World Report, January 14, 1985, at 73.

[28] *Big Board Hours Would Be Extended Under a Merger With Pacific Exchange*, Wall Street Journal, February 25, 1985, at 17.

[29] *Big Board, London Exchange Discuss Trading, Data Reporting Joint Ventures*, Wall Street Journal, January 7, 1985, at 3.

[30] The United States does not limit access by foreign broker-dealers to its securities markets. Foreign broker-dealers, moreover, can be members of United States exchanges. In many foreign countries, however, United States securities firms are restricted from selling and underwriting securities by regulations which do not apply to domestic firms. Although some of these restrictions have been reduced, restrictions still remain. *See infra* notes 61-63 and accompanying text.

[31] *See, e.g., United States Financial Firms Grab Growing Share of European Markets*, Wall Street Journal, February 25, 1985 at 1; *Citicorp to Buy London Dealer*, Wall Street Journal, February 22, 1985, at 32; *British Deal by Shearson*, New York Times, July 27, 1984, at D8.

[32] *Rebuff to Merrill in Tokyo Criticized*, New York Times, December 28, 1984, at D8.

[33] *A Regulatory Framework for Entry Into and Ownership Of The Ontario Securities Industry* (February 1985), A Report of the Ontario Securities Commission to the Minister of Consumer and Commercial Relations.

[34] The Commission's staff has analyzed the safety and efficiency of these proposed links and issued "no-action" letters under Section 17A of the Exchange Act. These letters advise that, under the terms and conditions set forth in the private agreement between the United States and foreign clearing agencies, the Commission staff will not recommend that the Commission take enforcement action if the foreign clearing agencies do not register as clearing agencies in the United States on account of their activities.

[35] *See* Letters from Dan W. Schneider, Deputy Associate Director, Division of Market Regulation, to Karen L. Saperstein, Assistant General Counsel, National Securities Clearing Corporation (October 24 and November 28, 1984).

[36] *See* Letter from Jerry R. Marlatt, Staff Attorney, Division of Market Regulation, to Alan H. Paley, Debevoise, Plimpton, Lyons and Gates (July 28, 1980).

[37] *See* Letter from Dan W. Schneider, Assistant Director, Division of Market Regulation, to Andrew M. Klein, Schiff, Hardin and Waite (March 25, 1982).

[38] *See* Letter from Richard G. Ketchum, Associate Director, Division of Market Regulation, to Robert Woldow, Vice President and General Counsel, National Securities Clearing Corporation (August 18, 1982).

These actions by broker-dealers, banks, securities markets, clearing agencies, and regulators represent initial steps to respond to the emergence of international trading and to anticipate further developments. In many respects, however, the dimensions of this increased international trading remain unclear. As a result, industry participants, securities markets, and regulatory bodies find it difficult to prepare for future developments in this area. This is a result in part of the absence of a central forum for discussion of these trends, and the issues raised by global trading of securities. By issuing this request for comment, the Commission hopes to provide that central forum to promote better coordination as international markets continue to develop.

II. Issues

While the speed and growth of international trading is difficult to predict, the trend towards increased trading before or after NYSE trading hours in United States securities does appear to be clear. However, this trading, involving primarily market professionals and institutional firms, may not raise substantial investor protection or market efficiency concerns for the United States securities markets. Simultaneous trading on an international basis raises substantially more complex questions. Similarly, more coordinated trading involving passing public investor orders from marketplace to marketplace throughout the twenty-four hour day raises a number of difficult issues. While it is far less clear that the amount of simultaneous or coordinated trading of shares of stock on an international basis will increase substantially, domestic exchanges and the NASD have indicated an increasing interest in exploring such arrangements with foreign markets.

Nevertheless, the Commission believes that it is important for the United States and foreign securities industries, markets, and regulators to consider ways of ensuring that where a global marketplace does develop, it is fair, efficient, and accessible to investors.[39] Accordingly, the Commission is soliciting comment on a number of significant issues raised by the growing internationalization of the securities trading markets. The Commission is also interested in receiving comment on any additional investor protection, competitive, or market efficiency concerns raised by the internationalization of secondary market trading.[40] Comments received will enable the Commission to consider what, if any, international negotiations or regulatory initiatives may be necessary to facilitate the increasing internationalization of the markets. In addition, the Commission anticipates that the comments will contribute to the consideration of these issues by the self-regulatory organizations, the securities industry, and investors, and will provide a forum for further discussion of these matters.

A. International Trading

As stocks increasingly are held outside of their country of origin, a number of initial steps have been taken to provide international trading opportunities for these stocks.[41] Yet the demand for this extended trading is unclear. Accordingly, the Commission, as a preliminary matter, requests comment generally on the need for actions to facilitate international trading. Specifically, the Commission requests comment on the extent to which extended trading opportunities are sought and used by investors at present. To what extent is this trading institutional, proprietary, or retail, and how does that effect the need for regulators to take actions to accommodate such trading? In addition, what use of these services is expected in the future? Is the demand for extended trading opportunities primarily based on a desire for liquidity during crisis conditions or during a rapidly moving market, or for ease in executing routine transactions? Finally, will extending trading opportunities result in spreading out existing trading over longer hours, or will greater trading volume result?

Assuming that conditions support increased international trading, the Commission requests comment on what conditions and structures should characterize international trading markets. Areas of discussion include market structure, clearance and settlement arrangements, and broker-dealer access to markets.

1. Market Structure

Several types of extended trading arrangements have been suggested as ways in which the international markets might develop. One possibility is that simultaneous trading in stocks by markets located in different countries could develop for at least part of the trading day.[42] As stocks increasingly list on exchanges in more than one country, these exchange markets may seek to attract order flow from foreign investors by extending their trading hours. As a result, trading of these stocks in markets in different countries could increasingly overlap.

Another possibility is increased coordination between domestic and foreign markets in the trading of multiply-traded stocks. This could occur through exchanges arranging for consecutive trading in stocks rather than simultaneous trading, possibly involving the passing of positions or open orders from exchange to exchange when trading ends in the earlier time zone. A further possibility is the rise of around-the-clock in-house trading by securities firms, as they expand their in-house trading capacity in foreign countries to accommodate the interest of foreign or United States clients that wish to trade outside normal business hours.[43] This could involve shifting their market making function and trading positions from office to office as working hours end in earlier time zones.

The use of these differing approaches would appear to have a number of consequences. For example, expansion of firm in-house trading capabilities to international dimensions would appear to require less time and capital to establish; indeed, a number of United States broker-dealers already have a substantial international presence.[44] At the same time, such an expanded upstairs trading capability, while useful in facilitating around-the-clock trading by institutional investors, probably would not provide opportunities for the same degree of retail market participation as exchange linkages. In addition, such upstairs trading would be much more difficult to monitor than expanded exchange activity.

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[39] *See* Commissioner Aulana L. Peters, *"The Securities Industry in 1985: Excellence Amidst Challenges,"* Address to the Securities Industry Association 1984 Annual Convention (November 29, 1984).

[40] The Commission recently requested comment on the steps that it should take to accommodate disclosure requirements for secondary trading subsequent to the public offering of securities in the United States by a foreign issuer. Multi-national Offerings Release, *supra* note 1, at 9284.

[41] *See supra* text accompanying notes 23–28.

[42] *See Big Board Pacific Tie Progresses*, New York Times, February 25, 1985, at D1. *See also supra* text accompanying notes 23–28.

[43] Third market makers such as Jefferies & Co., Inc. already provide their customers with the ability to execute trades in listed securities when United States stock exchanges are closed or have halted trading in a particular security. *See Jefferies' 'Third-Market' Trading often Steals Show from Exchanges*, Wall Street Journal, July 14, 1984, at 79.

[44] *See supra* text accompanying notes 31–32.

The Commission requests comment on the advantages and disadvantages of each approach. To the extent that commentators prefer one arrangement, the Commission requests commentators to discuss how such arrangements would operate, especially with reference to the handling of customer market and limit orders, and what structures are necessary for these arrangements to function effectively. In addition, the Commission requests commentators to address the specific market structure areas discussed below.

a. *Consolidated Reporting.* In the United States securities markets, member firms executing transactions in reported securities [45] during normal trading hours are required to report the trade price and size of transactions to a consolidated reporting system. These last sale reports from exchange and over-the-counter markets nationwide are collected in a central repository, updated continuously during regular trading hours, and publicly disseminated. The United States consolidated transaction reporting systems currently capture on a real-time basis the vast majority of the trading volume in reported securities.[46]

If the trading of reported securities becomes more international, the volume of transactions not captured in a consolidated system could increase. The Commission, therefore, solicits comment on whether transaction reporting requirements for participants in the United States securities markets should be expanded. In this connection, commentators are requested to discuss the volume of international trading currently occurring in United States stocks and the usefulness of making last sale information available for those transactions. Should member firms be required to report such trades to a consolidated system? If so, should they do so on a real-time basis even if those trades occurred outside of United States trading hours?

The Commission understands that, at this time, a substantial portion of foreign trading in United States stocks continues to occur in the OTC market and involves United States broker-dealers. In the future, however, more activity may occur in United States stocks either on foreign exchanges or in OTC transactions involving only foreign participants. The Commission requests comment on the desirability and practicability of developing an international consolidated reporting system for stocks traded globally on an active basis. The Commission recognizes that perhaps the principal obstacle to international transaction reporting is the lack of uniformity in reporting requirements. The Commission notes that, while some securities markets (*e.g.*, the NYSE) require that transactions be reported on a real-time basis, other (*e.g.*, the LSE) compile neither transaction nor volume reports for individual stocks.[47] Accordingly, the Commission solicits comments on whether uniform reporting requirements for securities traded internationally could be devised.[48] Comment is also requested on what level of international trading activity would be necessary before the cost of such a system is justified.[49]

b. *Consolidated Quotations.* In the United States securities markets, quotations in reported securities are collected during trading hours from exchanges and OTC market makers in reported stocks. These quotations are consolidated into a single quotation stream and disseminated to market participants. By referring to these consolidated quotations, market participants are able to direct their customer orders to the best market for execution.

The Commission requests comment on whether a consolidated quotation system is or will be needed internationally. The need for a consolidated quotation system is directly related to the amount of simultaneous trading occurring on an international basis. How active would simultaneous trading have to be for the consolidated quotations to be justified? How could the differing requirements concerning display of quotations be accommodated in a consolidated quotations system?

The Commission notes that major United States broker-dealers are presently disseminating quotations through foreign vendor systems before or after United States trading hours. In the future, United States information vendors may wish to disseminate those quotations in the United States. Comment is requested on whether domestic dissemination of foreign quotations will increase international after-hours trading by United States institutional or public investors. Comment is also requested on whether present quotation and vendor display regulatory requirements should be applicable to such dissemination.

The Commission also notes that the quotation reporting systems established for debt securities are considerably less developed than for reported equity securities. For the most part, information with respect to government and corporate debt securities in the United States is available only through privately sponsored wire or other communications systems. The principal information displayed is indications of interest (as opposed to firm bids or offers or reports of actual transactions), although some "brokers' brokers" disseminate firm quotations anonymously on behalf of dealers in debt securities.[50] Given that much of the expansion of activity in the international securities markets has involved the trading of debt securities,[51] comment is requested on whether the market information presently available in the international markets for debt is sufficient to ensure efficient pricing.

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[45] The term "reported security" means any listed or OTC equity security subject to an effective transaction reporting plan filed with the Commission pursuant to Rule 11Aa3–1 under the Securities Exchange Act of 1934 ("Exchange Act"). In the market for securities listed on an exchange, this central reporting is effected through the facilities of the exchange. In the market for securities traded solely OTC, this reporting takes place through NASDAQ terminals or by communicating with the NASDAQ headquarters.

[46] The Commission believes that National Association of Securities Dealers, Inc. ("NASD") rules require that OTC transactions in reported securities executed overseas during normal trading hours by NASD members be reported on a real-time basis. *See* NASD By-Laws, Article XVI, Schedule D, XIV, Section 2(a)(4); NASD By-Laws, Article XVIII, Schedule G, Section 2(a)(4). OTC trades executed outside of normal trading hours by member firms are required to be reported weekly rather than on a real-time basis. *Id.*

[47] *Big Board, London Exchange Discuss Trading, Data Reporting Joint Venture,* Wall Street Journal, January 7, 1985, at 3.

[48] The Commission also requests commentators to address the application of the Commission's short sale rule, Rule 10a–1 under the Exchange Act. The rule places certain restrictions on short sales in securities which are traded on a national securities exchange if transactions in such securities are reported pursuant to an "effective transaction reporting plan" under Rule 11Aa3–1 under the Act and information on such trades is made available on a real-time basis to vendors of securities information. The rule is intended to prevent the use of short sales to depress, or accelerate the depression of, a market for a security. Rule 10a–1 does not contain any exemption for short sales effected in international markets. The Commission requests commentators to address whether and under what circumstances an exemption would be appropriate.

[49] As an interim measure, the Commission solicits comment on whether it would be feasible to have an international consolidated reporting system that disseminates real-time last sale information for those markets that provide such data, while also compiling periodic volume data from markets lacking real-time last sale reporting.

[50] The NYSE and Amex maintain an odd-lot market for corporate and zero coupon government debt securities, and disseminate both quotation and transaction information on those securities. The transactions effected on the NYSE and Amex, however, constitute only a small portion of the overall market in debt securities and the quotes and sales reported are not necessarily reflective of the market as a whole.

[51] *See supra* text accompanying notes 1–7.

c. *Intermarket Linkages.* United States securities exchanges have developed an electronic system called ITS that links the participating exchange floors and the OTC market for multiply-traded listed securities.[52] Before ITS was developed in 1978, multiply-traded securities often were traded on different exchanges at disparate prices; these disparities often were not corrected by arbitrage activity. The establishment of ITS, coupled with consolidated last sale and quotation reporting, allowed orders to be routed from one market center to another so that transactions could be executed in the market that provided the best price.

With respect to the international marketplace, a number of securities already are being traded simultaneously in the securities markets of more than one country. For example, the securities of the issuers listed on both the NYSE and the LSE trade simultaneously during their overlapping trading hours. Presently, this trading presents few issues because activity in NYSE listed securities on the LSE is slight. As the international capital markets continue to develop, however, simultaneous international trading may become more commonplace, possible giving rise to disparities in prices in different markets, particularly if the same securities are traded in different currencies in each of those markets.

Assuming that this trading environment does develop, the Commission requests comment on whether pricing disparities are likely to result from this international multiple trading, and if so, whether arbitrage activity will bring the markets into line.[53] If commentators do not believe arbitrage will be sufficient, they are asked to address whether there should be mechanisms such as intermarket linkages to permit orders to be routed to the market with the best price.[54] Moreover, if public orders were routed through any such linkage, should there be more detailed disputeresolution systems in place and greater scrutiny of the investor protections provided by the rules of foreign markets? [55]

The Commission notes that much of the activity in United States securities now appears to occur away from foreign exchanges in the OTC market.[56] Commentators may wish to discuss the feasibility or desirability of any links between this foreign OTC trading and trading in United States securities market. Commentators are also requested to discuss whether any linkages developed are likely to involve exclusive agreements between a national securities exchange and a foreign market, and if so, whether that exclusivity would impose a burden on competition inconsistent with the provisions of the Exchange Act.

2. Securities Processing

In the United States, most securities transactions between broker-dealers are compared, cleared, and settled through systems operated by clearing agencies registered with the Commission under section 17A of the Exchange Act. The registered clearing agencies are the central components of the National Clearance and Settlement System. Generally, clearing agenices use automated systems to match trade data, compute net money and securities settlement obligations, and move securities between members' book-entry accounts to settle trades. In addition, clearing corporations, a type of clearing agency, guarantee their members' trade settlement obligations after securities netting. To ensure the financial integrity of the clearing agencies and to support clearing corporation guarantees, each clearing agency, among other safeguards, maintains a reserve fund of contributions from its members.

In foreign securities markets, securities clearance and settlement operations vary in function and efficiency. Some foreign securities markets have developed entities that are similar in function and regulatory authority to the United States clearing agency model, *e.g.*, the Canadian Depository for Securities Limited. Other foreign securities markets are in the process of developing modern, automated clearing agency facilities. In those cases, foreign securities market participants, and even foreign governments, depending on the country's securities regulatory scheme, will need to expend considerable time and capital to develop those facilities. Nevertheless, as the trend toward international trading increases, it will become increasingly important for foreign trading markets to establish efficient, safe, and accurate comparison, clearance, and settlement systems especially if they seek to link with United States securities markets and their respective clearing agencies.

The Commission requests comment on whether international links between United States and foreign clearing agencies are necessary for further expansion of international trading markets, and if so, what form future clearing links should take. For example, should these links be developed on an incremental basis, or should all concerned parties consider the creation of a centralized, internationally-governed clearing or depository entity for international trades? The Commission also requests comment on whether specific standards should be developed, as more international clearing links are proposed, to determine whether foreign clearing agencies should be permitted to participate in a link with a United States clearing agency or required to register as a clearing agency in the United States under Section 17A of the Exchange Act. This question could become crucial when a foreign clearing agency is not registered with the Commission and participates in the clearance and settlement of a high volume of transactions.[57]

Commentators should consider whether United States clearing agencies' normal safeguarding mechanisms will adequately protect the financial integrity of United States clearing agencies that accept such foreign clearing agencies as members.[58]

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[52] Rule 19c-3 securities, *i.e.*, listed securities not subject to exchange off-board trading restrictions, are the only securities in which the OTC market is linked to ITS.

[53] A number of securities are inter-listed on the major Canadian exchanges and in the United States on NASDAQ. For many of these inter-listed securities, it is our understanding that active markets exist in both the United States and Canada. The Commission would appreciate comments on trading experience in these inter-listed securities and, in particular, on whether arbitrage has been successful in preventing serious pricing disparities between the various markets for these securities.

[54] In this connection, commentators are requested to discuss whether use of such a linkage by public investors is feasible or desirable in light of the added currency risk and conversion expense generally involved in trading in a foreign market.

[55] The Commission understands that prior to implementing a linkage, the Chicago Mercantile Exchange and the Singapore International Monetary Exchange, Ltd. established procedures for the arbitration of disputes between customers and clearing members, between clearing members, and between the two exchanges. *See* CFTC CME-Simex Memorandum, *supra* note 23, at 44-48.

[56] This trend may not continue if the United States and foreign exchanges that are currently negotiating or contemplating links are successful in establishing these connections. On the other hand, this trend may increase as a result of the greater emphasis on OTC trading which appears to be anticipated by the British Government's white paper on the securities markets. *See* The [London] Stock Exchange, *A discussion Paper (April 1984).*

[57] The Commission also requests comment on the extent of the conditions required by the Division of Market Regulation in its existing no-action letters. *See supra* text accompanying notes 26-36. Are these conditions too extensive or not extensive enough to ensure prompt, accurate, efficient, and safe securities processing?

[58] These mechanisms protect the clearing agencies from financial loss by, among other things, requiring

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Similarly, comment is requested on whether United States clearing agencies should develop special admission standards for foreign clearing agencies that seek to link with United States clearing agencies through membership.

The Commission finally requests comment on the issues that arise when a United States clearing agency and a foreign clearing agency create a two-way link, *i.e.*, an interface. Although all approved links to date have been one-way,[59] the Commission believes that development of two-way interfaces reasonably can be anticipated. How can the Commission and United States clearing agencies ensure both the safeguarding of securities and funds in the United States National Clearance and Settlement System, and ultimately the protection of United States investors, when one or more United States clearing agencies is exposed to regulatory requirements and financial risks that could be very different from those encountered in this country?

3. Barriers to Entry

As the world capital markets become internationalized, securities trading and distributions increasingly are transcending national barriers. As discussed previously, the spread of trading in domestic stocks in other countries has led securities firms of many nations to ~~establish branch~~ offices or affiliates overseas. This international expansion is not limited to United States firms; foreign securities firms also are expanding both into the United States and into other countries as well. The Commission notes that, while foreign broker-dealers can easily register with the Commission as broker-dealers, and the United States securities exchanges and the NASD generally provide foreign firms with ready access to their markets, other nations and securities markets have erected explicit barriers to entry that prevent or restrict foreign firms from trading directly. Barriers of this nature, for example, are found in Canada,[60] Switzerland,[61] Great Britain,[62] and Japan.[63] The Commission requests comment on the effect of these barriers to international trading of securities and what actions, if any, should be taken to reduce these barriers.

The Commission also recognizes that, to the extent that national schemes for broker-dealer regulation differ substantially, they could constitute *de facto* barriers to entry by making it difficult for one nation's broker-dealers to qualify to trade in another country.[64] Accordingly, the Commission solicits comment on what barriers, if any, result from the broker-dealer regulation of various countries and whether this regulation significantly limits broker-dealers from one country from entering the markets of another.

B. Multinational Distributions of Securities

A recent release discussed various issues and concerns related to the distribution of securities in the context of the Securities Act.[65] A multinational distribution of securities also raises a number of issues under the Exchange Act, which regulates certain activities on the part of persons engaged in a distribution of securities.

For example, Rule 10b-6 under the Exchange Act is an antimanipulative provision that, subject to certain exceptions, prohibits persons who are engaged in a distribution [66] of securities from bidding for or purchasing, or inducing others to bid for or purchase, such securities (or certain related securities) until they have completed their participation in the distribution. The purpose of the rule is to prevent participants in a distribution from artificially conditioning the market for the securities in order to facilitate the distribution. The rule is designed to protect the integrity of the auction market as an independent pricing mechanism and thereby enhance investor confidence in the marketplace. Where the activities of non-United States distribution participants, or foreign affiliates of United States distribution participants, may have an impact on the United States securities markets, the Commission has taken the position that Rule 10b-6 applies to all of

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contributions to reserve funds, monitoring member activity, and requiring mark-to-the-market payments.

[59] That is, only the foreign clearing agencies have become members in the United States clearing agency; the United States clearing agency has not become a member of the foreign clearing agency.

[60] In Canada, any foreign broker-dealer wishing to do business must register with the relevant provincial securities regulator unless it is doing business in exempted securities. In Ontario, for example, new broker-dealer registrations are limited to applicants that are no more than twenty-five percent owned by non-residents with no single non-resident having more than a ten percent interest. The Ontario Securities Commission, however, has proposed a new, limited category of registration for firms with more than thirty percent ownership by non-residents. *See supra* note 33 and accompanying text. In Quebec, foreign broker-dealers may register without meeting similar requirements.

[61] In Switzerland, United States brokerage firms are precluded from becoming members of the Zurich Stock Exchange. United States firms, however, are allowed a fifty percent discount on commissions paid to a member firm of the Zurich Exchange. In addition, there is an informal understanding between the Swiss Banking Association and the foreign brokerage community restricting the solicitation of Swiss residents other than through Swiss banking intermediaries. The United States firms are understood to be able to service the accounts of United States citizens residing in Switzerland.

[62] Branches of United States firms are permitted to trade and underwrite securities in Great Britain. To date, however, no foreign brokerage firms have been admitted to membership on the LSE. Foreign entities currently are also precluded from owning an interest larger than 29.9% in an LSE member firm. These restrictions on foreign brokerage firms require them to trade British securities listed on the LSE through a member firm, thereby increasing their costs of doing business in Great Britian.

The LSE is preparing for two major deregulatory changes that will occur in 1986. As part of these developments, it is expected that foreign firms will be allowed to join the LSE. These changes will involve the elimination of fixed brokerage commissions and the terminaiton of the "single capacity" system whereby an LSE member firm is prohibited from engaging in more than one line of securities business.

[63] In Japan, although the Tokyo Stock Exchange has amended its rules to permit membership by foreign firms, no foreign firm has been able to acquire an exchange seat. *See supra* note 32 and accompanying text. On listed business, therefore, the foreign branches of United States securities firms must go through exchange members. As a partial accommodation, however, the foreign branches get a seventy-three percent discount from the standard commission. Nonetheless, foreign securities firms' participation in local markets is limited largely to the over-the-counter bond market, since by law all trades in listed securities must be "exchange transactions."

[64] The Commission also notes that continuous disclosure requirements for issuers under a country's securities laws may constitute a barrier to entry in that the cost of compliance may dissuade foreign companies from having their securities traded in another country's market. In this regard, section 12(b) of the Exchange Act requires foreign issuers traded on a national securities exchange to register with the Commission and file periodic reports similar to those filed by registered domestic companies. In addition, section 12(g) of the Exchange Act and Rules 12g-1 and 12g3-2 thereunder together require certain foreign issuers whose securities are traded on NASDAQ and who have over $3 million in assets and 300 United States shareholders to register with the Commission and file periodic reports. The Commission solicits comment on the effects, if any, which these requirements, and any other comparable requirements in foreign markets, have on the development of international trading markets.

[65] *See* Multinational Offerings Release, *supra* note 1.

[66] The term "distribution" is flexibly defined in Rule 10b-6 to distinguish transactions covered by the rule from ordinary trading transactions on the basis of the magnitude of the offering and the presence of special selling efforts and selling methods. The rule applies to primary and secondary distributions whether they are registered under the Securities Act or not.

the distribution participants and their affiliates.[67]

The Commission believes that the maintenance of investor confidence is critical to the continued strength of the securities markets, both in the United States and globally. Commentators are asked to address the extent to which the investor protections afforded by the Exchange Act can be maintained and coordinated with those of other countries, particularly in the context of distribution of securities on a multinational basis.[68]

C. International Enforcement Problems

The Commission and United States' securities market regulators, such as the self-regulatory organizations and state regulators, are responsible for ensuring the fairness and safety of the United States capital markets. To fulfill their responsibilities, the Commission and market regulators have implemented comprehensive surveillance mechanisms, and have worked together to enforce the securities laws. Through their combined efforts, the Commission and market regulators generally have been able to exercise effective oversight over trading in the United States securities markets by United States registered broker-dealers.

The Commission notes that the growing internationalization of the United States capital markets has made market surveillance and enforcement more difficult. Because the Commission's investigative subpoena authority is limited to United States citizens and persons within the United States, it cannot compel testimony from non-United States citizens located abroad. Further, because foreign law often does not allow for any investigative or pretrial discovery, Commission efforts to develop facts necessary to file a case where suspicious circumstances exist are often frustrated. Finally, the Commission has been required to engage in lengthy proceedings and negotiations to obtain information regarding transactions effected through banks or securities firms located in countries with secrecy or blocking laws.[69]

There are few surveillance or enforcement mechanisms in place to safeguard the integrity of securities trading conducted simultaneously in multiple international markets. This is a matter of concern to the Commission; as the global market becomes more developed, fraud or manipulation in multiply-listed securities may affect adversely the markets for those securities in the United States as well as other nations. Moreover, the efficacy of trading halts imposed by the Commission or a securities market could be impaired as more trading in United States stocks occurs abroad. The Commission seeks comment regarding the surveillance mechanisms which could be developed to scrutinize trading in multiple international markets as well as measures which could be taken to address the possible erosion of trading halts that could affect the integrity of the United States securities markets.

The Commission solicits public comment on the steps that should be taken to assure that both the United States capital markets and the developing global securities market operate fairly and safely. Specifically, the Commission asks commentators to address how systems to monitor international trading might be developed. In approving the BSE/ME linkage, the Commission noted that the exchanges had agreed to "cooperate fully" in the investigation of any questioned trade, including requiring member firms to provide information about the circumstances of such trades.[70] It also noted that the ME has rules that are comparable to those of the United States securities exchanges in a variety of areas, including manipulative trading practices, sales practices, and firm financial responsibility.

As other markets consider additional linkage, the Commission seeks comment on whether similar agreements to share exchange market surveillance data will be feasible, particularly if the regulatory environments of these markets have less in common than the United States and Canadian securities markets. The Commission also seeks comment on whether such informal written undertakings are or will continue to be sufficient to ensure meaningful cooperation on surveillance matters.

The Commission also asks commentators to address more generally how nations and securities markets might cooperate to ensure equivalent regulatory treatment and expedite enforcement of fraudulent or illegal securities transactions of an international scope. In particular, would it be practicable to reach bilateral or multinational agreements on securities law enforcement, possibly through the aegis of a coordinating body of national regulatory entities?[71]

C. Conclusion

In view of the increasing internationalization of the securities trading markets, the Commission is seeking comment on the future direction of those markets and a variety of issues relating to the operation of those trading markets on an international basis. The Commission solicits comment on the extent of international trading that is expected to develop, the need for structures such as consolidated reporting and quotation systems and order routing devices, clearance and settlement requirements, rules regulating multinational distributions of securities, and ways of improving international surveillance and regulatory mechanisms. The Commission also solicits comment on any other issues not addressed directly in the release that could be of importance in the developing world equity markets.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

Dated: April 18, 1985.

By the Commission.

John Wheeler,

Secretary.

[FR Doc. 85-9972 Filed 4-24-85; 8:45 am]

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[67] *See, e.g.*, Louis Vuitton S.A. (June 21, 1984) (French bank affiliate of U.S. underwriter of American Depositary Receipts); British Petroleum Company Limited (October 31, 1979) (secondary offering by United Kingdom distribution participants).

[68] Commentators may wish to focus, for example, on the extent to which to Commission's prior approach to international stabilization should be continued or refined. In this regard, underwriting syndicates in multinational firm commitment offerings have been permitted to adjust their stabilizing bids in compliance with Rule 10b-7 under the Exchange Act to account for fluctuations in the currencies of other countries in relation to the dollar during the period of the distribution. *See, e.g.*, Tricentrol Limited (July 2, 1980) (simultaneous offering in the United States, Great Britain and Canada).

[69] The Commission's recent waiver by conduct proposal was intended to stimulate discussion on how this enforcement problem might be addressed. *See* Securities Exchange Act Release No. 21186 (July 30, 1984). *See also* Multinational Offerings Release, *supra* note 1, at 9284.

[70] *See* Securities Exchange Act Release No. 21449 (November 1, 1984). In making this commitment, the ME noted that its rules allow it to furnish investigatory information to any other exchange regarding the activities of any of its members, a provision the ME indicated it deemed to encompass exchanging information with the BSE.

[71] *See* Commissioner Charles L. Marinaccio, "*Public Policy Issues Concerning the Subject of Tender Offers and the Developing International Equities Market*," Address to the Chicago Regional Group of the American Society of Corporate Securities (January 9, 1985).

PREPARED STATEMENT OF SENATOR WILLIAM PROXMIRE

Mr. Chairman, the internationalization of the world's capital markets is here to stay and the trend toward global trading and global markets is growing at a rapid pace.

The facts speak for themselves. One important indicator of growth has been the sharp rise in new Eurobond issues. In 1963 they totaled approximately $184 million while in 1984—the latest annual total available—total volume reached over $79 billion. With respect to the equity markets, a recent joint research effort of Arthur Anderson and Co. and the Securities Industry Association indicates that by 1988, annual foreign activity in domestic securities would increase from $134 to $167 billion with domestic activity in foreign securities increasing from $30 to $60 billion.

According to a 1985 survey by Euromoney magazine there were 328 stocks which it called genuine international equities and the Securities and Exchange Commission believes that within 5 years "it seems safe to predict that at least twice as many" of the 328 world-class companies listed for 1985 will have their stocks traded globally.

Meanwhile, U.S. firms have over 250 branches in 30 foreign countries, while close to 100 foreign firms have branches in the United States.

Contrary to popular belief, the largest securities firm in the world today is not an American company but a Japanese one—Nomura. Its current president predicts that under his successor, half of Nomura's business will be international. Even now, Nomura salesmen in Japan are telling customers that they should be 50 percent invested in Japanese securities, and the other 50 percent invested in foreign issues.

At the same time that foreign firms are expanding their activity here, U.S. firms are expanding their activities abroad—most particularly in Tokyo and London.

Just as our economies and currencies are becoming more interrelated, so are our capital markets. We are now witnessing the rapid development of primarily three financial centers—London, New York, and Tokyo—and the competition among these three dominant centers for increased market share in the world's financial services business is likely to intensify.

The world is truly becoming an electronic village and with the telecommunications revolution—which makes financial transactions virtually instantaneous—and with deregulation of the financial markets in the United States, Japan, and England, regulatory considerations will increasingly play an important factor as to the location in the world where financial transactions take place.

Take the explanation of S. Parker Gilbert, the chairman of Morgan Stanley, as to why Morgan Stanley is increasing its presence in Tokyo and London. He says: "I believe that there will be greater competition between New York, London, and Tokyo to become the leading global marketplace and the regulatory environment which finally emerges in each location could have an important impact. Just one more reason why our basic strategy calls for an important presence in each market."

Just as investment banking institutions jockey for position to best take advantage of this internationalization of the capital markets, so are stock exchanges and trading systems seeking to form links with one another and take advantage of listing and trading opportunities in world-class securities: For example, both the New York Stock Exchange and the NASD are talking with the London Stock Exchange; the American Stock Exchange; and the Boston Stock Exchange and the Montreal Stock Exchange currently operate a link between their markets.

At the same time that these links are occurring the amount of off-board trading—that is trading which is not done through any exchange, and which often occurs after the exchanges have closed, and around the clock—is increasing at a rapid pace.

According to one leading investment banker: "All exchanges worldwide will have to grapple with issues surrounding off-hours trading by members and consider how their systems should be adjusted to the realities of the global marketplace. Fundamental questions dealing with access cannot be ignored. As more is known, firms * * * will have to determine whether membership—if available—is the best answer or whether off-exchange dealer market-making is a more attractive opportunity."

According to a comment letter filed by Merrill Lynch with the SEC: "The development of an international market in world-class securities is well under way. It is largely a professional market and appears likely to remain so for the foreseeable future. Since there is little need or demand for individual U.S. investor participation, the need for customer protection rules is not as acute as it would be for an exchange or other market with a significant retail participation."

I have trouble with this view which would leave the individual behind in the trading of world-class securities and believe that methods should be examined for furthering individual participation.

And with respect to the future structure of the international securities markets, the SEC summarized the conflicting views as follows: "Several exchanges predicted that future global trading of world-class securities would occur around the clock through a network of interconnected exchanges, while other commentators asserted that around-the-clock in-house trading by U.S.-based or large foreign securities firms was more probable."

About 1½ years ago the Chairman of the Securities and Exchange Commission asked me whether there were any important areas I felt the Commission should be devoting more attention. In my written response dated October 23, 1984 I said the following: "I am more convinced than ever that an irreversible trend is underway as a result of telecommunications technology that will accelerate the trading of stocks and other instruments internationally." I suggested that the Commission begin to plan for the world trading system of the future so as to ensure United States involvement and leadership in that system in an ever increasingly competitive international arena.

More specifically I suggested that the Commission look into the following areas:

(1) The effects on trading practices of technological developments, including automation and computerization and advances in communications technology;

(2) The possible design and development of a worldwide contemporaneous clearing and settlements system, which is an absolutely essential ingredient to an effective internationalization of the capital markets;

(3) The transition from national trading systems to global trading systems, particularly in relation to the role and appropriate regulation of United States participants;

(4) Surveillance of global securities trading and the need for cooperative international oversight systems, exchanges of information, and international enforcement cooperation;

(5) Procedures for listing, disclosure and distribution of securities, particularly in relation to multinational and international issues of securities; and

(6) Institutional mechanisms for international cooperation in regulating securities and related transactions, particularly in relation to the appropriate role of United States regulatory bodies, self-regulatory organizations and private entities in the emerging global system.

The Commission has begun the task of looking into these issues and I would encourage them to continue and expand their efforts.

Mr. Chairman, I think the mere fact that you are holding hearings on these subjects today and tomorrow is extremely important in focusing the attention of both our private and our governmental sector to these vital issues. I have no preconception as to what the appropriate governmental or private sector response ought to be to the issues I have mentioned. But I do know that if we do not take the lead in addressing these subjects, the world will not wait for us and as sure as the day is long others will take advantage of competitive opportunities to develop regulatory and financial structures which will capture increasingly more of the international capital markets at our expense.

I believe that we, as well as our allies, are best served by working cooperatively to develop and harmonize, insofar as possible, our international markets. Through such cooperation, but with the United States leading the way, I believe our global markets will become more efficient, the world will become more interdependent, and the cause of capitalism will be further served. The benefits of developing a more integrated international capital market system would be immeasurable.

Mr. Chairman, I ask that my letter to SEC Chairman Shad dated October 23, 1984, as well as the Commission's release on the subject dated April 25, 1985, and the Commission's Summary of Comments on that release, be made a part of the record.

The **CHAIRMAN**. Senator D'Amato.

OPENING REMARKS OF SENATOR D'AMATO

Senator **D'AMATO**. Mr. Chairman, let me commend you for holding these hearings. I believe, Mr. Chairman, that as we look at the expansion of the international securities markets and what role we should play in them, I am encouraged that we see greater opportunities; however, I am concerned that the desire for uniform markets and trading practices may lower the requirements currently imposed by the major domestic stock exchanges.

Therefore, I am concerned that if the U.S. standards were dramatically lowered, investor protection and investor confidence in the markets will erode. And I think that is something that you've got to be careful about. It is very easy to blithely advance down the path of increased internationalization of the equity and debt markets while citing a litany of benefits of internationalization. I think we have to be cognizant of the potential that such a system poses for the safety and soundness of our financial systems and develop an appropriate regulatory response.

Mr. Chairman, I am going to ask that the full text of my statement be included in the record, as if read in its entirety.

So while I have been cognizant of the fact of the increasing internationalization, again, it seems to me that behooves us to be very cognizant of the balance necessary to give investor protection that we have worked so hard to maintain through the SEC.

[Prepared statement of Senator D'Amato follows:]

STATEMENT OF SENATOR ALFONSE D'AMATO

The focus of these hearings will be on the expansion of the international capital markets. Given the jurisdiction of this committee, we must examine how the internationalization of the capital markets has affected our domestic markets. I am particularly interested in how the growth of the international debt and equity markets has affected the economic and regulatory objectives of the Federal securities laws.

Within the last year, the SEC has proposed rules to facilitate multinational securities offerings. These rules were designed to encourage the growth and integration of U.S. and foreign markets. The growth of trading in so-called world class securities has grown enormously during the last few years. Rules designed to facilitate increased internationalization of the securities markets raise significant issues about how these securities will be traded and how investors will be protected.

The expansion of the international securities markets should proceed and domestic stock exchanges should be encouraged to play a greater role in these markets. However, I am concerned that the desire for uniform market and trading practices may lower the requirements currently imposed by the major domestic stock exchanges. Therefore, I am concerned that, if U.S. standards are dramatically lowered, investor protection and investor confidence in the market will erode. We must ensure that steps are taken so that U.S. companies and exchanges are able to compete and with their international counterparts, while preserving investor protections.

In their statements, the witnesses have suggested that competition that has resulted from the growth of the international securities markets and Eurobond markets has proven beneficial to issuers, investors and consumers. However, we should proceed with caution in this area because the arena in which market participants function is broader than the regulatory reach of the regulatory systems designed to constrain their conduct. While U.S. firms must be allowed to be competitive in these markets, I think that an examination of who the other players are and the regulatory systems in which they operate are legitimate concerns of the committee. Before we so blithely advance down the path of increased internationalization of the equity and debt markets while citing a litany of the benefits of internationalization, we must be cognizant of the potential threat that such a system poses for the safety and soundness of our financial system and develop an appropriate regulatory response.

The CHAIRMAN. Senator Dixon.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Banking Committee begins its examination of issues raised by the growing internationalization of capital markets. We have a distinguished and expert group of witnesses before the committee today. I look forward to their testimony, and their explanation of the problems and opportunities presented by this phenomena.

That capital markets operate increasingly across national boundaries is no longer open to question. The United States continues to be the largest capital market in the world but the Tokyo and London markets, in particular, are very large and growing rapidly. Trading which used to occur on only one market now takes place on a number of markets. Because of the development of communication technology, which can provide virtually instantaneous access to markets around the world, it is now possible to trade virtually around the clock.

We must examine very carefully whether the Federal statutory framework that governs our capital markets is adequate to handle the changes in the marketplace. We must also examine questions related to how these changes will affect investor protections and what kinds of new risks they present for U.S. markets and the U.S. economy in general.

I congratulate the chairman for scheduling hearings on this important subject. I believe it is essential for the committee to improve its understanding of the kinds of changes going on that affect our capital markets.

The **Chairman**. Thank you, Senator. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Mr. Chairman, first I want to commend you on holding hearings on what is, to many, I suppose, an abstract subject, but it is an important opportunity for those on this committee, and we hope, our other colleagues who have to make important public policy decisions, to get an overview, at least, of the emerging global market for capital.

We know, instinctively, at least, that the increasing internationalization of our capital markets raised a complex set of issues, at least three issues with respect to monetary policy, those having to do with the regulation of financial markets and the future course of international trades in goods and services.

There are, to my mind, a number of trends—three come to mind—that the full implications of which we, as policymakers, really need to understand and know a good deal more about.

First among those trends is that with the daily turnover in foreign exchange markets of about $150 billion or more. In other words, there is as much currency transactions in a single day as there is a deficit in the U.S. balance of statements account in a full year.

The concept of an independent U.S. monetary policy seems somehow a little outdated. Setting monetary policy would appear to be clearly an interdependent process with governments of other reserve currency countries, and it would appear to be increasingly involved with ensuring stability and coping with the potential for extreme volatility in exchange rates.

Second, and this is something that we as policymakers are sensitive to and need to be sensitive. It would appear that our regulators are severely limited today, in their reach and in their ability to deal with the safety and soundness of an international financial system.

Third, the massive turnover in foreign exchange is being, and being many times the value of underlying trade transactions, overturns old notions about the relation of trade and capital flows, and it is far from clear that the current account imbalances will necessarily be followed by smooth compensating adjustments, as economists would like to believe will automatically happen in the exchange rates to permit greater balance in world trade.

I must say, in significant part, it has been my experience that the administration has become increasingly aware of those trends. They have taken action in their light. They have implemented an increasingly multilateral approach to international economic and exchange rate policies.

What I like especially, Mr. Chairman, about the witnesses that we will be hearing from today and tomorrow, is that they are the practitioners. They are the major players and participants in the international capital market. They are both suppliers and users of capital. They are the innovators. They are the people who on the front line of dealing with all this and, hopefully, we will gain that deeper understanding we need to cope with those problems, whether it is exchange rate volatility, optimizing choices for policymakers, the limitations or need to extend regulation to ensure more safety and soundness.

I believe it is critical that we understand these issues better, and I commend you, Mr. Chairman, on the hearing.

The CHAIRMAN. Thank you, Senator. Senator Mattingly.

Senator MATTINGLY. Well, just briefly, Mr. Chairman. I would just like to commend you for holding the hearings, not only about the trend toward internationalization itself, but how it is going to be affecting U.S. competitiveness, specifically, and the international trade flows, more generally. So with that, Mr. Chairman, thank you very much, for holding the hearings.

The CHAIRMAN. Thank you, Senator Mattingly.

Our first panel is composed of Dennis Weatherstone, chairman of the executive committee, Morgan Guaranty Trust Co. of New York; Robert D. Hormats, vice president, Gomdman Sachs & Co.; Gordon Macklin, president, National Association of Securities Dealers, and Donald L. Calvin, executive vice president of the New York Stock Exchange.

Gentlemen, we are happy to have you with us.

Mr. Weatherstone, if you would like to begin, please.

STATEMENT OF DENNIS WEATHERSTONE, CHAIRMAN, EXECUTIVE COMMITTEE, J.P. MORGAN & CO. INC., AND MORGAN GUARANTY TRUST CO. OF NEW YORK

Mr. WEATHERSTONE. Mr. Chairman and members of the committee. My name is Dennis Weatherstone, and I am the chairman of the executive committee of J.P. Morgan & Co. Inc., and Morgan Guaranty Trust Co. of New York.

I appreciate the opportunity to appear before your committee today to discuss some of the important issues raised by the increasing internationalization of the world's capital markets.

VOLUME AND IMPORTANCE OF INTERNATIONAL CAPITAL FLOWS

The volume and importance of international capital flows have grown enormously in recent years, reflecting in large part the dramatic growth of international trade. The increasingly global nature of the capital markets is evidenced by the continued growth of the Eurobond market, the increasing distribution of equity securities in the international markets, the growing participation by foreign banking and investment firms in the domestic markets of many nations, and the move toward formalized links among stock exchanges in different countries.

Among the factors fueling the internationalization of the capital markets are the vast increase in the volume of world trade, nearly instantaneous global communications and greatly eased international air travel, the development of foreign exchange hedging techniques, the growth of multinational industrial and trading enterprises, and the increasingly large pools of funds that are managed by professional investment managers who are seeking to diversify their portfolios geographically.

Common sense suggests that the free flow of capital across international borders is beneficial for both investors and borrowers.

The Eurobond market, in which offerings are generally underwritten by international syndicates and securities are offered for sale simultaneously in a number of countries, provides an excellent example of the benefits of the internationalization of the capital markets. The Eurobond market has grown far more rapidly in the last decade than the corporate debt market in the United States.

There are a number of reasons for this growth. Borrowers in the Eurobond market have realized significant cost savings by accessing new pools of investors. Borrowers have also realized savings by being able to structure transactions in the Eurobond market more quickly—and with fewer regulatory burdens—than in our domestic market.

Moreover, vigorous competition in the Eurobond market has led to great innovation in that market, benefiting both investors and issuers.

Last year, the top four book running underwriters had a 27-percent market share, as compared with a 65-percent share for the top four underwriters in the U.S. corporate debt market.

Innovations have included the so-called bought deal and extensive use of debt warrants. Currency and interest rate swaps have also played a prominent role in the growth of the Eurobond market.

It should also be stressed that commercial banking organizations, both United States and foreign, have played a fundamental role in the development and rapid growth of the Eurobond market. Morgan Guaranty, Ltd., a subsidiary of the Morgan Bank, has been one of the top 10 book runners in terms of dollar volume of issues underwritten in each of the past 3 years and last year ranked third in this category.

SHIFT IN CORPORATION FUNDING

Global integration of capital markets has been accompanied by an historic shift in the way major corporations raise funds, thereby significantly altering the traditional role of commercial banks. Corporations now increasingly use public markets, both United States and foreign, rather than bank loans, as their principal source of short- and medium-term funding. This change is reflected in the borrowing patterns of manufacturing corporations with assets of more than $1 billion. In 1974, such corporations satisfied 59 percent of their short-term funding needs with bank loans, while turning to commercial paper for only 33 percent of such needs. By 1985, these percentages had reversed, so that only 26 percent of short-term corporate borrowing was done through bank loans and 52 percent was through commercial paper.

The decreased use of traditional bank intermediation requires commercial banks to adapt to changed market circumstances if they are to maintain their vitality as providers of financial services. Today, banks and other financial institutions can better serve their clients' needs if they are free to use their broad expertise to offer financing in a variety of forms—not only by making bank loans, but also by underwriting and distributing securities. For American banking organizations, this has been possible in the Euromarkets, but they have been prevented in their own home market from satisfying their customers' needs through the securities markets.

Compounding this problem is the fact that a number of the major international competitors of U.S. banks are permitted by the International Banking Act of 1978 to conduct both commercial and investment banking opportunities in the United States. For example, Deutsche Bank, the largest commercial bank in Germany, underwrites corporate securities in the United States through its subsidiary, Deutsche Bank Capital Corp., and at the same time, maintains a full service commercial banking branch in New York. Similarly, Credit Suisse, one of the major Swiss banks, owns a substantial interest in the First Boston Corp., one of the leading investment banks in the United States, while it too operates commercial banking branches in this country. Indeed, the International Banking Act of 1978 permits more than a dozen foreign commercial banks to engage simultaneously in commercial banking and corporate securities underwriting in this country.

AMERICAN BANKS NEED SAME OPPORTUNITY AS EUROPEAN BANKS

While we support this involvement in both activities, we believe that American bank holding companies should have the same opportunities, subject to appropriate regulatory supervision. We believe that the internationalization of the capital markets, particularly in light of the Eurobond experience, calls for major revision of the Glass-Steagall Act, which is an increasingly serious impediment to capital market efficiency in the United States.

As a Nation, we have a vast need for capital to support economic growth and to foster new industries and jobs. Future improvements in productivity and industrial competitiveness depend in a very tangible way on the capacity of our financial markets to raise large amounts of capital cheaply and to allocate such capital efficiently.

As demonstrated by experience in the Eurobond market, if freed from unnecessary regulatory restraints, American commercial bank affiliates could play a significant role in increasing competition and spurring innovation in our securities markets. In the U.S. municipal securities and commercial paper markets, the competition provided by commercial banks has already helped to narrow spreads and reduce the interest rates paid by borrowers. Moreover, the successful participation by commercial banking organizations in the Eurobond market demonstrates that they can engage in corporate securities activities without jeopardizing their safety and soundness and without creating conflict of interest problems.

The convergence of world financial markets means that the walls between different countries' financial markets, as well as the walls between sectors of financial markets, are crumbling. The lesson of history is that market participants have a knack for finding the most efficient ways to do business and the most advantageous locations in which to do it.

In order to assure continued leadership of our capital markets and of American financial institutions, our laws need to be updated to take full advantage of the benefits of free competition in capital markets. Other countries, including Britain, Japan, Germany, France, and Switzerland, are already in the process of making swift and dramatic changes so as to participate more successfully in world financial markets. A revision of our statutory framework would not only enhance the position of the United States in world financial markets but would also strengthen our banking system and permit borrowers to benefit from increased competition in the U.S. securities markets.

Thank you.

[The complete prepared statement follows:]

Statement of Dennis Weatherstone
Chairman of the Executive Committee
of
J. P. Morgan & Co. Incorporated
and
Morgan Guaranty Trust Company of New York
before the
Committee on Banking, Housing, and Urban Affairs
United States Senate
February 26, 1986
Washington, D. C.

Mr. Chairman and Members of the Committee:

My name is Dennis Weatherstone and I am the Chairman of the Executive Committee of J. P. Morgan & Co. Incorporated and Morgan Guaranty Trust Company of New York. I appreciate the opportunity to appear before your Committee today to discuss some of the important issues raised by the increasing internationalization of the world's capital markets.

I commend the Committee for its decision to hold these hearings, because it is very much in the interests of this country that United States financial institutions remain major intermediaries in the world's capital markets and that our financial centers attract their fair share of international business, along with the jobs and other economic benefits such business brings. Certain changes in our laws and regulations have already been made in order to adapt to the new realities of a world marketplace for capital, but more needs to be done if American markets and American institutions are not to be left behind.

The volume and importance of international capital flows have grown enormously in recent years, reflecting in large part the dramatic growth of international trade. The increasingly global nature of the capital markets is evidenced in a number of ways:

- the continued growth of the Eurobond market. In 1985, borrowers issued over $133 billion of debt securities in the Eurobond market, of which $28 billion--or over 20% of the total--were sold by American issuers, including certain government-related entities such as the Federal National Mortgage Association and the Student Loan Marketing Association.

- the increasing distribution of equity securities in the international markets. According to a recent issue of Euromoney, in the past three years over 30 corporations have offered an aggregate of more than $2.2 billion of equity securities in international markets.

- the growing participation by foreign banking and investment firms in the domestic markets of many nations. Foreign-owned firms will soon be allowed to become stock exchange members in London, and a limited number of foreign firms have been allowed to acquire stock exchange seats in Tokyo.

- the move toward formalized links among stock exchanges in different countries. For example, in the United States, the National Association of Securities Dealers has recently announced arrangements to exchange quotations with the London Stock Exchange.

Among the factors fueling the internationalization of the capital markets are:

- the vast increase in the volume of world trade, which in turn has required a corresponding growth in global capital flows. For example, over the past 25 years, U.S. trade has grown more than twice as fast as our domestic economy as a whole.

- nearly instantaneous global communications.

- the development of a variety of foreign exchange hedging techniques, which enable investors to reduce the risk of investments in securities denominated in foreign currencies and permit borrowers to fix the cost of borrowings in foreign currencies.

- the growth of multinational industrial and trading enterprises, which require sources of financing and investment capital in the various countries where they do business.

- the increasing sophistication of international securities clearance systems such as Euro-clear and Cedel, which reduce the operational costs of issuing and investing in foreign securities.

- the increasingly large pools of funds that are managed by professional investment managers who are seeking to diversify their portfolios geographically.

Common sense suggests that the free flow of capital across international borders is beneficial for both investors and borrowers. In recent years, the United States in particular has been a prime beneficiary of such capital flows.

The Eurobond market, in which offerings are generally underwritten by international syndicates and securities are offered for sale simultaneously in a number of countries, provides an excellent example of the benefits of the internationalization of the capital markets. The Eurobond market has grown far more rapidly in the last decade than the corporate debt market in the United States.

There are a number of reasons for this growth. Borrowers in the Eurobond market have realized significant cost savings by accessing new pools of investors. Borrowers have also realized savings by being able to structure transactions in the Eurobond market more quickly--and with fewer regulatory burdens--than in our domestic market.

Moreover, vigorous competition in the Eurobond market (where last year the top four "book running" underwriters had a 27% market share as compared with a 65% share for the top four underwriters in the U.S. corporate debt market) has led to greater innovation in that market, benefitting both investors and issuers. One of the most notable innovations developed in the Eurobond market is the so-called bought deal, in which underwriters commit to purchase a new issue of securities at a fixed price and thereby insulate the borrower from market risk during the syndication period. The SEC's implementation of Rule 415 has brought this Eurobond market benefit to our domestic market. Another innovation in the Eurobond market is the sale of debt warrants, which can dramatically lower a borrower's cost of financing. Currency and interest rate swaps have also played a prominent role in the growth of the Eurobond market by allowing borrowers to access additional investors and to lower their costs by taking advantage of different investors' varying currency and interest rate preferences across various markets.

It should be stressed that commercial banking organizations, both U.S. and foreign, have played a fundamental role in the development and rapid growth of the Eurobond market. In 1985, three of the top six book runners and 13 of the top 25 book runners in the Eurobond market were commercial banks or bank affiliates. Morgan Guaranty Ltd, a subsidiary of The Morgan Bank, has been one of the top 10 book runners in terms of dollar volume of issues underwritten in each of the past three years and last year ranked third in this category.

One of the primary lessons to be learned from the success of the Eurobond market is that its legal framework has been conducive to efficient market operation. If we want the United States to maintain its central position in the world's financial markets, we must be willing to make the necessary changes in our laws and regulations. In the past, the U.S. has taken steps which, although well-intentioned, actually encouraged the growth of the Euromarket at the expense of our domestic markets. Regulation Q, which set interest rate ceilings on time and savings deposits, sent international depositors and borrowers to London and other foreign financial centers, and the voluntary credit restraint program announced in 1964 forced many of our corporations to issue securities overseas. Our interest equalization tax, adopted in 1964, restricted the access of foreign borrowers to U.S. capital markets by penalizing American investors who purchased foreign securities. These actions--although designed to reduce United States balance of payments deficits--provided a strong incentive to both American and foreign entities to raise funds outside the United States.

In contrast, appropriate legislative changes can greatly benefit our domestic markets. A prime example was the action taken by Congress, state legislatures and the Federal Reserve Board in the early 1980's to authorize international banking facilities in this country. Such facilities--which essentially permit banks to conduct international deposit and lending activities at domestic offices on the same basis as if conducted offshore--have successfully attracted a substantial amount of international business back to the United States.

Obviously, if financial markets in the United States were able to attract significant amounts of business that would otherwise be done abroad, substantial domestic economic benefits would result. The importance of the financial sector to our domestic economy was shown in a recent study which found that the financial industry produced 46% of the new jobs in New York City's private economy from 1977 to 1983.

Adaptation of the U.S. legal framework for financial services in response to the internationalization of the capital markets is needed. Global integration of capital markets has been accompanied by an historic shift in the way major corporations raise funds, thereby significantly altering the traditional role of commercial banks. Corporations now increasingly use public markets, both U.S. and foreign, rather than bank loans as their principal source of short and medium term funding. This change is reflected in the borrowing patterns of manufacturing corporations with assets of more than $1 billion. In 1974, such corporations satisfied 59% of their short-term funding needs with bank loans, while turning to commercial paper for only 33% of such needs. By 1985, these percentages had reversed so that only 26% of short-term corporate borrowing was done through bank loans, and 52% was through commercial paper.

This increased use of public markets in part reflects the greater availability of information about issuers. This permits investors to assess a direct investment in a business without channelling their funds to banking institutions which in turn make loans using deposited funds. The increased use of public markets also results from the higher cost of bank lending, due in part to factors such as reserve requirements on bank deposits.

The decreased use of traditional bank intermediation is a natural result of the increasing efficiency of capital markets. This trend requires commercial banks to adapt to changed market circumstances if they are to maintain their vitality as providers of financial services. Today, banks and other financial institutions can better serve their clients' needs if they are free to use their broad expertise to offer financing in a variety of forms--not only by making bank loans but also by underwriting and distributing securities. For American banking organizations, this has been possible in the Euromarkets, but they have been prevented in their own home market from satisfying their customers' needs in the securities markets.

Compounding this problem is the fact that a number of the major international competitors of U.S. banks are permitted by the International Banking Act of 1978 to conduct both commercial and investment banking operations in the United States. For example, Deutsche Bank, the largest commercial bank in Germany, underwrites corporate securities in the United States through its subsidiary, Deutsche Bank Capital Corporation, and, at the same time, maintains a full-service commercial banking branch in New York. Similarly, Credit Suisse, one of the major Swiss banks, owns a substantial interest in The First Boston Corporation, one of the leading investment banks in the United States, while it too operates commercial banking branches in this country. Indeed, the International Banking Act of 1978 permits more than a dozen foreign commercial banks to engage simultaneously in commercial banking and corporate securities underwriting in this country. While we support this involvement in both activities, we believe that American bank holding companies should have the same opportunities, subject to appropriate regulatory supervision.

We also note that the 1978 Act discriminates among foreign banks, since those foreign banks that did not have American investment banking affiliates on the grandfather date are barred from underwriting corporate securities if they have a commercial banking presence here.

We believe that the internationalization of the capital markets--particularly in light of the Eurobond experience--calls for major revision of the Glass-Steagall Act, which is an increasingly serious impediment to capital market efficiency in the United States. As a nation, we have a vast need for capital to support economic growth and to foster new industries and jobs. Future improvements in productivity and industrial competitiveness depend in a very tangible way on the capacity of our financial markets to raise large amounts of capital cheaply and to allocate such capital efficiently.

Strong evidence suggests that Glass-Steagall's restraint of competition works against both public and private organizations--from municipal governments to small entrepreneurial businesses to large corporations--in their efforts to raise capital and finance business activities at the lowest possible cost.

As demonstrated by experience in the Eurobond market, if freed from unnecessary regulatory restraints, American commercial bank affiliates could play a significant role in increasing competition and spurring innovation in our securities markets. In the U.S. municipal securities and commercial paper markets, the competition provided by commercial banks has already helped to narrow spreads and reduce the interest rates paid by borrowers. Moreover, the successful participation by commercial banking organizations in the Eurobond market demonstrates that they can engage in corporate securities activities without jeopardizing their safety and soundness and without creating conflict of interest problems.

The convergence of world financial markets means that the walls between different countries' financial markets--as well as the walls between sectors of financial markets--are crumbling. The lesson of history is that market participants have a knack for finding the most efficient ways to do business and the most advantageous locations in which to do it.

In order to assure the continued leadership of our capital markets and of American financial institutions, our laws must be updated to take full advantage of the benefits of free competition in capital markets. Other countries--including Britain, Japan, Germany, France and Switzerland--are already in the process of making swift and dramatic changes so as to participate more successfully in world financial markets. A revision of our statutory framework would not only enhance the position of the United States in world financial markets, but would also strengthen our banking system and permit borrowers to benefit from increased competition in the U.S. securities markets.

The CHAIRMAN. Thank you, Mr. Weatherstone. Mr. Hormats.

STATEMENT OF ROBERT D. HORMATS, VICE PRESIDENT, GOLDMAN, SACHS & CO., DIRECTOR, GOLDMAN SACHS INTERNATIONAL CORP.

Mr. HORMATS. Thank you, Mr. Chairman. I very much appreciate the opportunity to testify today on a subject that is of major importance both to the securities industry at large and to the American economy.

As Mr. Weatherstone has pointed out very well, an efficient financial system is an extremely important component in an efficient U.S. economy; the two are closely interrelated.

Let me briefly describe some of the changes that have taken place in world finance over the last several years and then discuss a few points relating to how the United States is dealing, and might better deal, with them.

NEW RANGE OF INNOVATIVE TECHNIQUES

One of the major changes in the international financial picture has been the move in 1973 from a crumbling fixed-rate system to a floating exchange rate system. With the volatility that has occurred in current markets from the early part of the 1970's on until now, American corporations and American financial institutions have had to design a range of innovative techniques to deal with currency exposures. Options markets have developed dramatically over the last several years, in various major currencies.

There have been all sorts of developments in futures markets and currency swaps, a whole range of new techniques have been developed to hedge against or protect against major currency risks.

Second, borrowers have become extremely sophisticated in choosing the optimal currencies and financial instruments in which to borrow. Today borrowers can go to the Euromarket and borrow. They can go to Singapore. They can to go Hong Kong. They can go to Tokyo. And the currency in which one borrows really doesn't mean that much. Because if you can borrow in favorable terms in one currency, but you want an obligation in another, you can simply do a currency swap. Thus, the techniques that have been developed over the last several years to deal with this internationalization have been quite spectacular and change is still occurring.

Third, the portfolios of institutional buyers of securities have expanded dramatically. Today, roughly three-fourths of all stock purchases are done by institutional investors, and institutional investors are increasingly internationally minded.

To give you an example, Mr. Chairman, today total pension fund assets amount to $1.1 trillion in this country, which is up from about $400 billion in 1980. The investment of those pension funds in foreign securities has increased even more rapidly from about $3.4 billion in 1980 to $35 billion today; our expectations are that by 1990 that figure could reach $120 to $140 billion. Americans are becoming increasingly international minded in terms of where they put their money, and institutions, in particular, for reasons of diversification, are buying in the German, French, London, and Tokyo markets and elsewhere.

The fourth major change has been the dramatic liberalization in capital controls—a major relaxation of capital and foreign exchange restrictions all around the world. Over the last several years the Japanese have made major steps toward liberalization, indeed, highly successful steps.

The big bang is taking place in Britain in the fall. The French version of the big bang is going to take place. These are all efforts to deregulate securities markets. That means, simply, more opportunities for borrowers and more opportunities for lenders.

EURO AND JAPANESE MARKETS

The expansion of the Euromarket and the Japanese market are the two major financial developments over the last several years. The Euromarket, of course, is much older. It is an enormous market today, roughly $2.2 trillion. The bond market, Eurobond market, in terms of corporate issues, today is larger than that of the United States and growing. Americans can either issue bonds in New York, London in Europe or other capital centers.

The United States has adopted some of the European underwriting techniques. Rule 415 is really a derivation of a practice used in European markets for so-called "shelf registration" or "bought issues." This practice tends to reduce the amount of time required between the decision to go to the market and actually going to the market. The issue is registered, ready on the shelf, ready to go.

For the borrower there are a tremendous number of alternatives. The commercial paper market today is the world's most efficient market. Commercial paper enables the corporate borrower, particularly highly creditworthy corporate borrowers, to go to the market and get huge amounts of funds in virtually whatever short-term maturity the borrower wants.

This is a cheaper market than the direct bank borrowing market, a cheaper market than borrowing based on the London interbank offered rate [LIBOR]. It is extremely efficient. There is also the U.S. bond market, which tends to have longer term maturities and tends to be fixed rate, although there are some floating rate issues in the U.S. market as well.

Now the Euromarket has been the one that has dramatically expanded, in large measure because it is an offshore and a largely unregulated market. You can do a lot of things in the Euromarket that you cannot do in the American market.

In the European market there are an enormous range of possibilities for the issuer of securities. Less regulation which makes it much easier to do issues. The Euromarket is also much more oriented toward floating securities than the American market. The American market tends to be largely fixed, somewhat larger term market. There have been a lot of innovations in that market—RUF's [revolving underwriting facilities] NIF's [note issuance facilities]. A whole range of things of that sort have developed over the last several years, and this all has expanded rather dramatically.

It is also, I think, important to note that the Euromarket facilities issue in a number of currencies. Dollars are the main denomination of borrowing, but one can now issue securities in ECU's, deutschemarks, and virtually every other major currency. And there are other smaller versions of Euromarkets abroad. For instance, Singapore has its own type of "offshore market," a relatively open market, where a lot of new borrowing opportunities exist.

So the world financial market is dramatically expanding and borrowing and lending opportunities are growing.

Now Japan has, as I mentioned, liberalized rather dramatically. Japan is the world's biggest exporter of capital—because it has the widest gap between the savings rate and the investment rate. Japanese buyers of securities have bought American and European securities in large amounts—including a very substantial amount of Treasury securities, which has helped the United States Government to finance its debt. And of course, with that expansion of the Japanese market comes the expansion of the role of Japanese securities firms in the European market, and in the American market. Japanese firms go to these markets to service their Japanese customers but also because they, like other securities firms, want to play a role in these various markets.

So it is entirely to be expected that the Japanese are going to play a greater role in world finance. They are very competitive. The Japanese do have their own version of a Glass-Steagall Act at home, which tends to separate their security firms from their banks; but in Europe, their security firms and banks can play a somewhat more similar, although not precisely the same role.

The equity market has seen a dramatic change over the last few years. Last year 14 American issuers, instead of turning to New York or some regional market of the United States, issued their equities on the London market. In turn, a number of Europeans have, in the form of ADR's or in the form of direct listings, put their stocks on the New York Exchange.

EASE OF INTERNATIONAL TRADE

So today I can sit in my office and make a trade just as easily in London or Tokyo as in New York; and someone sitting in Tokyo can do virtually the same thing in London or New York. You have an enormously integrated market with stocks being issued by a company in one country, and listed in another, and traded in a third country. Singapore Airlines stock, for example, has listed on the Singapore Stock Exchange, but sold in Japan, in the United States and in Europe. And increasingly, these global equity issues are becoming extremely important ways of raising equity for companies.

The last point relates to the question of competitiveness of American firms and the competitiveness of the American financial market. American regulations were designed for a period in which the United States was by far the largest and most important of the world capital markets. If you wanted to do a big debt issue 15, 20 years ago you would normally have come to the United States. You might have used the Euromarket. Still, the American market was the big game in town. It is not so much the case anymore. We in the United States have a number of regulations on our books which have tended to place impediments in the way of individual borrowers. Borrowers who are shopping around may seek to issue their securities in a less regulated market.

We should not overregulate our own market. There is a risk if our market is more regulated than the other markets issuers will go elsewhere. Senator D'Amato has made the point that we want to protect the investor. That is certainly true. Everyone in the securities industry knows that if you don't protect the investor, the industry itself loses credibility.

However, at Japan and Britain they protect their investors quite well with fewer regulations. And I think that while we do not need to take their approaches precisely as they are, and they certainly won't take ours, we do need to take a look at the overall question of regulation to make sure that we are not so overregulated that we drive a lot of the business offshore, where none of our regulations apply And that balance is one that I think this committee will be getting into later.

The investment banking community understands the need for certain regulations. We certainly understand the reasons behind Glass-Steagall. As people in our industry have testified, we don't see a need to change that. But we do think there are a number of other types of regulations—and Mr. Calvin will talk about this a little bit later—which do bear a substantial amount of scrutiny and can be improved upon to foster an improved and strengthened securities industry.

Finally, in response to a point Mr. Weatherstone has made, I think the securities industry in this country is very competitive. I don't think the problem is a lack of competition. If you look at the share of markets of the various investment banks, you wil find that this is a pretty competitive industry. One figure that illustrates that is implicit in his testimony; that is, the efficiency of the commercial paper market.

The problem is that there are fewer regulations abroad than in the United States, and more and more we are going to see business that would otherwise go here and would otherwise fall within the general purview of our regulatory authorities, moving abroad, away from our securities industries, and away from our ability to regulate.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

Testimony Before
Senate Committee on Banking
February 26, 1986

Robert D. Hormats
Vice President, Goldman, Sachs & Co.
Director, Goldman Sachs International Corp.

Internationalization of Capital Markets

During the last 15 years the world has witnessed a veritable explosion in capital mobility, in new borrowing techniques and in new opportunities for investors. Within national financial markets rules are being liberalized. Internationally, there has been a major relaxation of exchange controls, discriminatory taxes and entrance to foreign institutions. Past lines of delineation between commercial banks, investment banks and "financial supermarkets" have become blurred.

Four major factors have contributed to this change. First, the end of the Bretton Woods system of fixed exchange rates. That system began to crack in the late 60s and was replaced by a floating rate system (or "non-system") in 1973. And we have seen a period of unprecedented currency volatility. As a result, investment bankers and commercial bankers have devoted a great deal of energy and effort to finding ways to reduce the cost of such volatility for their clients and themselves through a host of new hedging, swapping, and other financial techniques.

Second, borrowers have become highly sophisticated in choosing the optimal currencies and financial instruments in which to borrow in the global financial marketplace. Increasingly, they seek to borrow directly from the owners of capital rather than through financial intermediaries, such as commercial banks, and they are less and less concerned about what country they borrow in. If a borrower can borrow cheaper in Currency A than Currency B, but wants to incur a repayment obligation in Currency B rather than in Currency A, it can borrow in Currency A and swap the obligation with a counterparty which prefers repayment obligations in Currency A, but has found it more attractive to borrow in Currency B.

Third, institutional buyers of securities, who today account for roughly 3/4 of all stock purchases, are becoming increasingly internationally minded. The 1978 change in rules governing the investment practice of U.S. pension funds, which made it clear that pension fund managers could invest overseas, triggered a sharp increase in pension fund purchases of non-U.S. securities. Pension fund managers now compete actively with one another to improve their returns on investment. Total pension fund assets today amount to $1.1 trillion, up from roughly $400 billion in 1980; their investment in foreign securities have grown even more rapidly during that period -- from $3.4 billion to $35 billion. Further dramatic growth, to a level of $140 billion, is likely by 1990.

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Fourth, the general liberalization of controls on the movement of capital and foreign exchange in Japan, Britain, Germany and Switzerland has speeded up the internationalization which was already in process. Past controls on the flow of funds produced distortions and inefficiencies, in much the same way as do trade barriers and subsidies. Financial deregulation comes in response to a recognition that such distortions are harmful. It has permitted citizens of these countries to make large investments and borrowings in foreign securities. And it has attracted growing amounts of securities business to these markets.

The Euromarket

Several foreign financial markets have gained enormous prominence during this period. The U.S. remains the world's largest capital market by a substantial margin. The U.S. stock market accounts for more than 50% of the capitalization of all world equities; and the U.S. bond market accounts for a large portion of world debt issues. But the Euromarket has become increasingly important. The overall Euro-currency market (i.e. total Euro-deposits outstanding) has grown from about $200 billion in 1972 to roughly $2.5 trillion today. And in 1985 the Eurodollar bond market surpassed the U.S. dollar corporate bond market in volume of new transactions.

At its inception, the Euromarket was based largely on dollars deposited in banks outside the borders of the U.S., mainly in London. It is now made up of both securities and bank deposits issued in several currencies outside of the borders of their home countries. It is an "offshore market" and an unregulated one. The Eurobond market is largely one in which commercial banks or investment banks bid competitively to underwrite securities by agreeing to purchase them at a competitive price from the issuer. After buying them, they resell them to other buyers, or hold them on their books.

A similar underwriting approach was adopted in 1982 in the U.S. -- known as Rule 415. This permits companies to preregister an issue of stocks or bonds and place the issue on the "shelf" for as much as two years. Then, when the issuer believes market conditions to be right, it calls a number of investment banks and asks them to "buy" the issue. The "buyer" subsequently resells the issue. This approach means that the large deals are "bought" by those investment banks with substantial amounts of capital to put at risk in any given deal and with a strong distribution network so that they do not need to hold the securities for any longer than is necessary. The investment bank will normally form a group of other investment banks to help sell the securities to investors, although on occasion it will sell the entire issue itself. This approach contrasts with the pre-1982 practice of, in effect, "pre-selling" deals during the period of several weeks in which the S.E.C. was reviewing an issuer's documentation. This practice limited considerably the investment banker's risk in any transaction.

Borrowing Approaches

A potential borrower (either American or non-American) will consider a variety of markets, and a variety of techniques before making a borrowing decision. Depending on the borrower's needs and credit standing, it can issue U.S. commercial paper (short-term unsecured paper) of 30, 60 or 90 days in duration which can be turned over at maturity; commercial paper programs generally last for several years. This is the cheapest and most flexible form of direct borrowing, and is generally at rates of interest well below those charged by banks. An American or foreign entity can also issue bonds in the U.S. This requires S.E.C. registration and a rating from one of the major American rating agencies. Such bonds can be issued with maturities of from 6 months to 40 years, at some "spread" above Treasury interest rates. The U.S. debt securities market is largely (90% in 1985) fixed rate. Foreign issues -- Yankee Bonds -- totalled roughly $5 billion.

Or the borrower can go to the Euromarket. In the Euromarket, disclosure requirements are more flexible than in the U.S. and there is no S.E.C. registration. In Europe a high quality American borrower can actually at times float loans at less than U.S. Treasury interest rates. Buyers of securities will often accept less than U.S. Treasury interest rates because they can avoid withholding taxes on interest payments, which are frequently charged on domestic issues in their home countries. One of the major reasons for the Euromarket's strength is its unregulated character.

The Euromarket also has other interesting techniques for borrowing. Floating Rate Notes in the Euromarket were designed to protect borrowers and lenders against the risks of major movements in interest rates. Interest rates are adjusted every 3 or 6 months. For borrowers, terms of FRNs are normally cheaper then syndicated loans from banks, and carry longer maturities. The buyer of these notes is protected against the risk of an interest rate increase. If interest rates go up the holder of the note gets the higher rate, but of course the converse is true when rates go down. Over one-half of all Eurodollar issues are floating rate issues. There are, of course, also U.S. domestic FRNs.

There are a variety of other financing techniques known as RUFs (Revolving Underwriting Facilities), NIFs (Note Issuance Facilities), etc. Both fall somewhere between a bank loan and a security. A borrower agrees to issue short-term notes and a group of commercial banks agree to buy them at a rate of interest which bears a relationship to the banks' lending rate (LIBOR) if they cannot be sold to others at a lower interest rate.

The Euromarket is an area in which American commercial banks and investment banks compete without the inhibitions of the Glass-Steagall Act. All of the large U.S. investment banks and commercial banks have a substantial presence in London to conduct this business. Both types of banks, however, must compete with very sophisticated and effective European financial institutions and, increasingly, the Japanese banks and security houses. In 1985 the major lead managers of Eurobonds include Credit Suisse/First Boston, Morgan Guaranty, Nomura, Merrill Lynch, Deutsche Bank, Salomon, UBS, Morgan Stanley, Goldman Sachs and Swiss Bank Corp.

One can assume with a high degree of confidence that this market will grow substantially in coming years, much as it has in the past. Doubtless the U.S. market will lose business to this market, and non-American firms will likely get a smaller share of that market than of business in the U.S.

New Alternatives for Lenders

Just as security issuers have taken advantage of a broad range of global opportunities, so have buyers of securities. As mentioned earlier, pension funds and other institutions have dramatically expanded their purchase of foreign securities. This results from their desire to diversify and to take advantage of growth in foreign markets. U.S. holdings of shares in Western European companies in 1984 were roughly $12 billion, and U.S. holdings of Japanese equity securities amounted to $3 billion. These institutions are served by investment banks which analyze foreign stocks just as they do stocks of domestic companies, thereby giving potential buyers sufficient information to make informed choices among such companies.

Moreover, instant telecommunications enables me to sit at my desk and know about an event in Germany or Japan just as quickly as someone sitting in Frankfurt or Tokyo, and to undertake a transaction just as quickly. And investment banks have expanded their presence in foreign capital markets. Taking advantage of this presence and knowledge, they increasingly trade foreign stocks abroad (London, Tokyo, Frankfurt, Singapore, Hong Kong) as well as in their own home market. Volume of trading by non-nationals on the New York, Tokyo and London stock exchanges has risen dramatically from 1980 to 1984 -- in New York from $75 billion to $124 billion, in Tokyo from $19 billion to $73 billion, in London from $9 billion to $17 billion.

Japan

A word should be said about the dramatic financial liberalization in Japan. Japan is the world's largest exporter of capital. Its savings are considerably higher than its domestic capital needs. It, therefore, has been a very important participant in international capital markets. Net purchases of foreign bonds by Japanese investors grew from $950 million in 1980 to $65 billion in 1985.

Japan's citizens and institutions have bought large amounts of stocks and debt instruments in the U.S., including substantial amounts of Treasury bonds. Indeed, an important part of the ability of the U.S. to lower interest rates during this recovery has been the influence of Japanese capital. Japanese commercial and investment banks understandably have increased their business here as their own clients become more and more involved in the U.S. economy and attracted to American securities. The same is true in the Euromarket. The main Japanese firms have experienced roughly a doubling of their lead managership of Eurobond issues both in volume and number of deals from 1984 to 1985. In 1985 eight Japanese securities houses and banks ranked among the top 50 underwriters of Eurobond issues totalling $15 billion. Japanese banks and securities companies, whose roles at home are differentiated, because Japan has its own version of Glass-Steagall Act, can both underwrite new issues in the Euromarket. Although Japanese banks have not been allowed by their government to lead-manage new issues of Japanese issuers, this may change soon -- which will add to the strength of these banks. Nonetheless, Japanese securities firms are likely to retain a very strong position at home and in Europe.

Equities

While much of the discussion about capital markets has focussed on debt instruments, it might be useful to describe to this committee some of the developments occurring in the equities area. International syndications of equities are becoming increasingly important. As individual buyers become more sophisticated and issuers, particularly in small countries, "outgrow their domestic markets" there has been growing interest among companies in selling their equities in a number of markets. Three basic approaches have been used:

- o An offering made in the issuer's own domestic market but distributed globally to international investors (British Telecom, Singapore Airlines);
- o An issue targetted to and specifically structured for a particular foreign market (Japanese commercial banks issued in Swiss francs)

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The CHAIRMAN. Thank you. Mr. Macklin.

STATEMENT OF GORDON S. MACKLIN, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Mr. MACKLIN. Thank you, Mr. Chairman.

The National Association of Securities Dealers, Inc. [NASD] is deeply interested in the internationalization of securities markets, as evidenced by an agreement with the London Stock Exchange for the exchange of securities quotations and trade data and discussions with other overseas markets and market data vendors.

We are, therefore, pleased to be invited to participate in these hearings, and commend you, Mr. Chairman, the committee members and the committee staff for your foresight in conducting hearings on this important subject at this time.

I would like to refer you back to Mr. Hormats' remarks about the growth in trading volume, which brings many of us to focus on this subject at this time. I will skip those parts of my remarks that essentially say the same thing over again.

GLOBAL MARKET FOR SECURITIES

The escalating interest in the international marketplace is reflected across the board in the securities industry with large, medium, and small securities firms endeavoring to meet investor demand with the equities of other countries. By way of illustration, Nomura Securities, the largest securities firm in the world, has one of the most ambitious goals for international activity. Nomura salesmen in Japan tell customers that they should be 50 percent invested in Japanese securities and the other 50 percent in foreign issues.

Another illustration, Merrill Lynch International has over 600 international account executives in 48 offices in 28 countries, other than the United States and Canada. Merrill has been trading National Association of Securities Dealers automated quotation system [NASDAQ] stocks around the clock for some time. The firm passes its book around the world from New York to Tokyo to London and back to New York. Shearson Lehman/American Express has 20 foreign offices in 17 countries, with plans for more.

Across the board, United States brokerage firms now have over 250 branches in 30 foreign countries, exclusive of Canada and Mexico, with 110 foreign firms, have branches in the United States.

The experience of firms indicates that more and more sophisticated customers want global asset management. When customers think in these terms, firms and markets respond.

Perhaps the most concrete example of growth in the international market is the increasing interest in the world securities marketplaces in linking their trading facilities to create a global market.

Commencing in April, the London Stock Exchange will disseminate quotations on some 300 NASDAQ securities throughout the United Kingdom, and the NASD will disseminate quotations on a similar number of London securities to NASDAQ level 2 and 3 subscribers. That is, to broker dealers and primarily to institutions.

This is a pilot arrangement that permits future expansion to include trade reports and conceivably executions—computerized executions through that linkage. That linkage was facilitated by another interesting development in internationalization. The London Exchange has developed an entirely new quotation system that is modeled closely on our American-based NASDAQ system. When that system becomes operational later this year, the exchange of data will be even easier.

The Association of International Bond Dealers is considering building an automated system to improve the eurobond market. The movement of more international markets toward similar structures and similar technology is driven by the growing internalization of security trading and will only serve to encourage growth in trading.

Technology is making possible the international quotation, execution, and clearing linkages for the global stock market of tomorrow. The large international securities firms are building in-house systems that will allow them to participate fully in these emerging international linkages.

Medium-size firms are building cross-border communications systems with comparable firms in other countries.

One of the basic needs of the international firms and international firm groups is for solid international price quotations.

Private vendor organizations as well as the organized markets will play a crucial role in getting price information for various markets and market makers to the end users, the world securities firms.

GROWING MARKET FOR INTERNATIONAL QUOTATION INFORMATION

The vendors are betting there will be a rapidly growing market for international quotation information.

The utilization of the global network for the execution of transactions will probably develop also, but more slowly.

Reuters today offers execution services in a joint venture with Instanet. However, if the domestic experience on NASDAQ's system, with its small order execution system, is any guide, firms will prefer to execute orders by telephone until their volume of business and economics of their volume dictate otherwise.

In the clearance and settlement area, international linkages can be expected to develop more rapidly. Clearance and settlement represents a large part of security firms trading costs, such a large part that the firms will put pressure on the markets to bring these costs down.

One example of what has already happened in this area has been provided by the Canadian Depository for Securities, the clearinghouse for the Toronto and Montreal Stock Exchanges. They have a linkage with our Depository Trust in New York.

In another example, the National Securities Clearing Corp. [NSCC], in this country has announced the establishment of an international securities clearing subsidiary to support domestic firms through bilateral linkages with central clearing and depository organizations abroad. That organization is already having discussions with the London Stock Exchange.

A worldwide network of clearance and settlement arrangements will come about in due time. Utilization of existing industry organizations, such as NSCC and the Depository Trust Co., as interface mechanisms for domestic broker/dealers should provide the United States with a major cost advantage.

The international clearance and settlement network will necessarily involve the establishment of rules and procedures in such areas as eligibility standards for participating securities firms, settlement at multiple depositories, and currency exchange rules.

The requirements of clearance and settlement processes will help to create much of the regulatory framework for the world market for growth stocks.

All of these developments offer opportunities, not only for big multinational issuers, the major securities firms, and powerful financial institutions, but also for service to a global universe of growth companies, a highly diversified universe of investors, and to the economic growth of many countries.

We see two kinds of organizations servicing the professionals in the global market for equities—private vendors, both domestic and international, on the one hand, and user controlled market service systems like NASDAQ, the securities exchanges, and National Securities Clearing Corp. on the other hand.

Individual vendors already provide quotations and market data worldwide and have a potential to provide many other services.

NEW TECHNOLOGIES

At NASDAQ we are exploring new technologies for marketplace efficiency and reliability. Small two-way satellite dishes offer the potential for more reliable service over wider geographical areas at lower cost. Local computer networking to improve processing efficiency and interfaces for new types of terminals are undergoing research and development.

Further, we are doubling our single-day capacity and building the securities industry's first complete market support backup system to assure the uninterrupted operation of our market.

The volume and pattern of international securities dealings that has developed and the expertise to date demonstrates that considerable benefit can be gained by permitting foreign operations in today's marketplace to mature further.

Substantial foreign demand for U.S. securities is being satisfied by the evolving market structure. Foreign reaction to premature or unnecessary American regulatory initiatives could easily stifle that demand.

Our association believes that Congress and the SEC should exercise restraint in considering any proposals for applying the formalized structure to the international marketplace at this time. Proposing concepts that are unique to the American marketplace may be counterproductive and appear to be an attempt at regimented integration of foreign and U.S. markets.

We believe that during this evolutionary period of the international marketplace it would be more appropriate to encourage trading among international markets and linkages between clearing and settlement systems in order to provide the experience and the economic incentive necessary to foster the expansion of trading opportunities.

This approach provides a climate for cooperative regulatory initiatives that can be accepted in foreign jurisdictions without undue disruption to existing trading patterns or negative reactions by foreign governments or their regulatory bodies.

We believe Congress and the SEC should consider the needs of the diverse international financial interests represented in the international marketplace. This consideration should include recognition of the regulatory approach of other countries. Under a scheme of continuing review, it may prompt an evolution of foreign markets to the acceptance of certain of our laws where appropriate.

NEED OF REAPPRAISAL OF U.S. SECURITIES LAWS

Also important in this regard is a careful, objective reappraisal of all aspects of domestic securities laws applicable to foreign transactions to assure that they do not constitute barriers to the development of an international marketplace.

Concurrently, the laws and practices of foreign countries should be reviewed to identify foreign barriers to entry and to competition by our markets. Steps should be initiated to seek removal of these barriers.

In sum, the NASD believes that the proper approach to regulation of international markets is to monitor developments in these markets and to encourage trade. As experience is gained, refinements can be made to regulatory surveillance programs consistent with any identified need and with the self-regulatory organizations working in concert with the SEC.

We again appreciate your attention to these issues and are anxious to work with you as time passes.

[The complete prepared statement follows:]

- An issue made entirely in the international markets.

As mentioned above, the U.S. equity market remains by far the world's largest; Japan's equity market is in second place and growing. The U.K. is third. Each country's domestic firms tend to dominate the management of these issues. Japanese securities are of growing interest to U.S. institutions, and are second only to those of American firms in institutional portfolios. Some are listed in the U.S.; some trade in the form of ADRs. American firms participate actively in this business; and will be able to do so more actively in the future now that three of us have been admitted to membership on the Tokyo Stock Exchange.

In Europe interest in Japanese equities is at least as great as that in U.S. equities. It is several times greater than U.S. investment in Japanese equities. European purchases of Japanese securities in 1985 were roughly ¥10 trillion, or about $500 million. Japanese firms do 75-80% of this business. This is logical, appropriate and likely to continue. American firms participate in Europe as in the U.S. as sellers of Japanese issues; and they serve as market makers and advisers to their clients. American firms have an impressive research capability which enables them to make comparisons among corporations within and among important sectors of the economy. For instance, investors today take a global approach to most sectors, e.g. autos, chemicals, textiles, pharmaceuticals, etc. Our automobile industries analysts today cover General Motors, Ford, Chrysler, Volvo and Jaguar as well as Honda, Subaru and Toyota. Because investors want to be able to judge Honda stock relative to GM stock, or Toyota relative to Ford, they need the analysis of investment banks which have the ability to provide research in a wide range of stocks. Such information is an extremely important part of the equity business. And our international research coverage results in business for us with both U.S. and non-U.S. investors.

Ability to Compete

From time to time alarms have been heard regarding the increasing role foreign banks are playing in the U.S. and Europe, and the ability of U.S. investment and commercial banks to compete. Let me say at the outset that growing foreign competition is a reality which we fully accept. We also expect to be given the right to compete on a similar basis in foreign markets as others do in ours. For the most part we have that right, or see it on the horizon. We are pleased with the liberalization which has occurred, and is planned, in Tokyo, London, Frankfurt and Paris. This is in the interest of greater efficiency and greater competitiveness.

The investment banking arena in the U.S. is enormously competitive. Firms must constantly bid competitively with one another for business and develop new products which meet the needs of clients. In an integrated world financial market, large foreign institutions will participate in this process.

The U.S. has a highly developed set of rules to protect investors. An effective S.E.C. strengthens confidence of borrowers and lenders in our capital markets. But the U.S. needs to take care that we don't overregulate. London and Tokyo protect their investors quite well with considerably less regulation on new issues than in the U.S. The U.S. has already lost securities business to Europe and Japan. Last year 14 new equity issues were launched by U.S.

companies in London. Billions in bonds of U.S. corporations have been floated there. The easier it is for Americans (or citizens of the other nations) to buy and sell securities in foreign markets, the greater the incentive for U.S. firms to issue in financial markets less regulated than our own. We risk more business going offshore if we cannot work out better regulations which serve the investing community, while reducing some cumbersome requirements on issuers.

We today face major world competition. But our rules and regulations were largely designed for an era in which the American market was clearly dominant and major issuers were almost automatically attracted to it.

Both the investment banking industry and the commercial banking industry are important to the American economy, but they serve different functions -- which need to be subject by different types of regulations. But let me also add at this point that commercial banks are important to investment banks as we are to them. We are concerned by the problems they face -- energy loans, loans to developing countries, agricultural loans, etc. I am particularly troubled, as are my colleagues in the commercial banking sector, about the provision in the House Tax Reform Bill that would reduce the foreign tax credits that U.S. banks may claim for gross withholding taxes paid on interest earned on loans made to foreign borrowers. Other provisions that would eliminate the bad debt reserve for a large number of banks and the deferral of foreign external income would also be harmful. A strong U.S. banking system is of considerable importance at home and internationally. Such provisions would harm it considerably.

The internationalization of capital markets injects a healthy element of competition in the world economy. To be sure there are risks. And prudence will be required to avoid disguising that risk or shifting it to those who cannot bear it. But the more efficient capital markets are, the better it will be for both borrowers and lenders, and for the corporations whose financial health is so critical to a healthy economy. But our capital markets must keep up with those of other nations. We need to ensure that our regulations and laws do not put our institutions at a competitive disadvantage.

TESTIMONY
of
GORDON S. MACKLIN, PRESIDENT
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

February 26, 1986

My name is Gordon S. Macklin and I am President of the National Association of Securities Dealers, Inc. ("NASD"). With me today is Frank J. Wilson, Executive Vice President, Legal and Compliance of the NASD.

The NASD is registered with the Securities and Exchange Commission ("SEC") as a national securities association pursuant to the Securities Exchange Act of 1934. The NASD's primary purpose is to provide for self-regulation of the over-the-counter securites market. At this time, the NASD has over 6,300 broker/dealer members employing over 330,000 salespersons and principals. The NASD employs over 1,300 people and carries out its examination, disciplinary and other regulatory responsibilities through its Washington headquarters and 14 district offices located in major cities throughout the country.

In addition, the NASD operates two wholly-owned subsidiary corporations, NASDAQ, Inc. and NASD Market Services Inc. NASDAQ, Inc. maintains and operates the NASDAQ Automated Quotation System. This system is a computerized system by which NASD members exchange quotations for securities traded over-the-counter. NASD Market Services enables NASD members to enhance their capabilities in the areas of transaction execution, trade

reporting and clearance of transactions through the use of facilities offered by the Corporation.

The NASD is deeply interested in the internationalization of securities markets, as evidenced by an agreement with the London Stock Exchange for the exchange of securities quotation and trade data and discussions with other overseas markets and market data vendors. We are therefore pleased to be invited to participate in these hearings and commend Chairman Garn, Committee members, and the Committee's staff for your foresight in conducting hearings on this important topic at this time.

The invitation for these hearings included a list of 25 questions on internationalization. Rather than respond to each of those questions separately, we would like to review the continuing expansion in international markets and the role of various firms and market centers in that expansion, the crucial role technology plays in the international markets, and the need for caution in devising a regulatory system for the international markets.

The Expanding International Market

Growth in Trading Volume--The United States securities industry stands at the threshold of expanded participation in major world capital markets that presently account for aggregate annual equity trading of approximately $1.8 trillion. A recent joint research effort of Arthur Andersen & Company and the

Securities Industry Association indicates that by 1988, annual foreign activity in domestic securities would increase from $134 billion to $167 billion with domestic activity in foreign securities increasing from $30 billion to $60 billion. This would mean an increase in the cross-border share of world equity trading from less that 12 percent to more than 16 percent of the total. These projections may be conservative, however, as they appear to be based on a restructuring of the markets for a limited number of very large capitalization securities. Euromoney magazine has identified 236 such stocks (of which 20 are on NASDAQ) which it calls "genuine international equities." IBM, with a market value of some $75 billion., led the list, and all but the 236th company had a market value in excess of $225 million.

In 1980, total foreign purchases and sales of domestic equities amounted to $75 billion. By 1983, the figure had risen to $134 billion. In the first half of 1985, foreign purchases and sales of domestic equities were running at an annual rate of $148 billion. This may portend an escalating pace of change in the international arena, and trading could surpass the SIA projection of $167 billion before 1988.

In 1985, trading of nearly 300 American Depository Receipts and foreign issues in the NASDAQ market aggregated 1.4 billion shares, with a dollar value of trading of $12.5 billion. This represented nearly one-third of U.S. total activity in foreign equities. Concurrent with this development, foreign activity in NASDAQ issues is also increasing. This is

demonstrated by the more than 14,500 terminals (up to 35% over 1984) located in 36 foreign countries which now receive NASDAQ information and by the more than 350 foreign institutions that now hold NASDAQ stocks.

Growth in Firm Activity--The escalating interest in the international marketplace is reflected across the board in the securities industry with large, medium and small securities firms endeavoring to meet investor demand for the equities of other countries. By way of illustration, Nomura Securities, the largest securities firm in the world, has one of the most ambitious goals for international activity. Its current President predicts that under his successor, half of Nomura's business will be international. Even now, Nomura salesmen in Japan are telling customers that they should be 50% invested in Japanese securities, and the other 50% invested in foreign issues. In recent months, Nomura has taken steps to become more involved in both traditional international activity and in the coming world market for growth stocks. In the first instance, Nomura management is making a broad commitment to NASDAQ securities.

Merrill Lynch International has over 600 international account executives in 48 offices in 28 countries other than the U.S. and Canada. In the last two years, Merrill has enlarged its international research department from 8 analysts to 30. The newest aspect of Merrill's international activity is that its OTC Marketing Department has begun to focus on foreign issues in the firm's 400 branches in the United States, and expects this function to become as important as its marketing of NASDAQ issues.

Merrill has been trading NASDAQ stocks around the clock for some time. The firm passes its book around the world, from New York to Tokyo to London and back to New York. It does the same thing for debt security trading in European and United States CDs, commercial paper and bonds. Among foreign equities, Merrill trades Japanese, Amsterdam, Singapore and Hong Kong stocks on a 24-hour basis.

The First Boston Corporation trades some 120 European and Asian equity securities, the majority of which are NASDAQ securities. First Boston maintains trading desks in New York, London and Tokyo and passes the book in these securities around the world, thereby utilizing the firm's trading capital almost 24 hours each day.

London-based Morgan Grenfell has 27 offices in 21 countries. While it has long concentrated on international investment management and project finance, in 1984 it acquired leading British stockbrokering and stockjobbing firms, in order to enter the field of international securities research, sales and trading.

Shearson Lehman/American Express has 20 foreign offices in 17 countries, with plans for more. Its foreign equity business has grown, especially in the past two years, because of greater domestic pension fund, mutual fund and individual investor interest in foreign stocks. The firm makes markets in London before the U.S. market opens, shifts the market for United

States issues to New York when New York opens, and shifts the market for foreign issues to New York after London closes.

The foreign equity business of Bernard L. Madoff in New York is entirely with foreign brokers having interests in U.S. stocks. Its activity has been increasing over the past five years, and especially in the last year. This has been accompanied by a significant increase in business done with foreign customers after normal domestic trading hours.

Arnhold and S. Bleichroeder, on the other hand, conducts a business in foreign securities for U.S. institutions. Activity has increased markedly over the past year, due to the interest of pension funds, index funds and ERISA accounts seeking better diversification. Arnhold and S. Bleichroeder does an increasing business in foreign stocks after their foreign markets have closed.

Carl Marks & Company, Inc. located in New York primarily conducts a business in foreign securities on a wholesale basis for a geographically dispersed network of domestic and foreign brokerage firms thus providing current access to most world markets. The firm anticipates further market internationalization at a tremendously accelerated rate over the next several years.

Across the board, United States firms now have over 250 branches in 30 foreign countries (exclusive of Canada and Mexico), while 110 foreign firms have branches in the United States. The experiences of individual firms and the overall expansion of foreign branches indicate that, more and more, sophisticated customers want global asset management. When customers think in these terms, firms and markets respond.

As the experience of firms also indicates, some customers want to deal during their normal business hours. In September, NASDAQ and the exchanges expanded trading hours in response to these needs. The push for the 24-hour world market is on in earnest. In a sense, there really will not be a true world market until trading is continuous, around the clock.

In the Arthur Andersen-SIA study to which we have referred, the financial services industry executives who were polled agreed that their greatest future costs would be, first, in people and, second, in technology. This suggests that 24-hour trading is eventually going to be a joint enterprise between people and machines. When the economics justifies the investment, more computerized automatic executions will take place, and the people at the machines will be on duty around the clock. Technology is a critical component in the equation of keeping costs down, and satellite communications, fiber-optic cable transmissions and other advances will lead the way. Those firms which most efficiently use new technology will be those which gain larger shares of the growing world equity market.

To ascertain the extent and type of international business and business arrangements of securities firms, the NASD is conducting a special study of its members and has sent a questionnaire to about 315 firms that we believe may conduct a foreign securities business. Responses are far from complete, with numerous of the largest firms yet to respond and we cannot

yet provide statistically reliable numbers. We are obtaining a better indication, however, of what is occurring at the firm level. NASD member firms have a wide variety of relationships with foreign broker-dealers ranging from wholly-owned U.S. subsidiaries of major foreign firms to wholly-owned foreign subsidiaries of U.S. firms. U.S. firms have operating arrangements with foreign brokers including: clearing, execution and clearance, execution only, clearance and custody and omnibus accounts (a customer of the foreign broker). The principal countries represented, by those who have responded thus far, in order of importance are not suprising. They are: the UK, Canada, Switserland, Germany, Hong Kong, France, Japan and Singapore. These responding to date have memberships on the London, Tokyo, Hong Kong, Singapore, and the Canadian exchanges.

The responding firms see as the major obstacles to the growth of international equity trading the clearance and settlement processes, compliance with foreign laws, U.S. securities laws and foreign restrictions on U.S. overseas firms. As this study is completed, we will be happy to provide the Committee with additional data on patterns of activity by securities firms.

Interest in Market Linkages--Perhaps the most concrete example of growth in the international market is the increasing interest of the world's securities marketplaces to link their trading facilities and create a true global market. Commencing in April, pursuant to an agreement between the NASD and the London Stock Exchange, the Exchange will disseminate quotations on some 300 NASDAQ securities throughout the United Kingdom and the NASD will disseminate quotations on a similar number of London securities to NASDAQ Level 2/3 terminals. This is a pilot arrangement that permits future expansion to include trade reports and, conceivably, executions through the linkage.

The NASDAQ-London linkage was facilitated by another interesting development in internationalization. The London Exchange has developed an entirely new quotation system that is modelled closely on NASDAQ. When that system becomes operational later this year, exchange of data will be even easier. The Association of International Bond Dealers is considering also building a system based on NASDAQ to improve their marketplace. The movement of more international markets toward similar structures and similar technology is driven by the growing internationalization of securities trading, and will only serve to encourage more growth in that trading.

Notwithstanding the increasing amount of discussion and coverage in the financial press devoted to international trading systems and the underlying growth of the international equity market, however, this is still a market in an embryonic state. In this regard, the NASD believes that Congress and the SEC should exercise restraint in consideration of any mandate for application of formalized market structure elements to the international marketplace, such as suggestions for a uniform system of consolidated quotations and transaction reporting or formalized market linkages of the nature currently in use in domestic markets. These concepts are unique to the American

marketplace and may be counter-productive in terms of their appearance of regimented integration of foreign and domestic markets. During this evolutionary period of the international marketplace, concentration on the control of foreign markets and the practices unique to each may tend to restrain rather than enhance international cooperation and development of competitively motivated market interaction.

A significant contribution can be made at this juncture by focusing upon the expansion of opportunities for participation in the international market by domestic securities firms and investors. Those issues posed by the Committee relative to the structure of the future international market will be addressed in large part by the genius of industry participants. Evolutionary beginnings to such are already being seen.

The Catalyst of Technology

Technology is making possible the international quotation, execution and clearing linkages for the global stock market of tomorrow.

The large international securities firms -- the Merrill Lynchs, the Nomuras, the Shearson Lehmans, the Goldman Sachs, the Dean Witters, the Grieveson Grants and Morgan Grenfells, the Credit Suisse First Bostons and others -- all are building in-house systems that will allow them to participate fully in these emerging international linkages. In this category, we also find highly capitalized combinations like BZW which was put together by Barclay, de Zoete & Bevan and Wedd Durlacher; and, the Mercury International Group formed by S.G. Warburg, Rowe & Pittman, and Akroyd & Smithers, which will become operational next year.

Medium-size firms are building cross-border communications systems with each other. A case in point is the COLT system by which the New York firm of Herzog, Heine and Geduld communicates with its United States trading partners. COLT was built by the FEMCON Associates; it is now being expanded into Great Britian, for communications with Herzog's British and European trading partners, and the Software Sciences Company is re-engineering COLT for multi-currency trading. Also, Instinet is expanding its system into the U.K. and Europe with its eye on the Far East next.

The need of the international firms and international firm groups is for solid international price quotations. The linkage between NASDAQ and the London Stock Exchange will directly respond to this need. More such intermarket linkages, and on a larger scale, will no doubt follow.

Private vendor organizations will play a crucial part in getting price information from the various markets and market makers to the end users -- the world securities firms. For example, Reuters' MONITOR system serves thousands of terminals in securities firms worldwide. Reuters' goal is the collection and centralization of price information from all markets, and thus being able to display the global inside quotations -- the highest bids and lowest offers anywhere -- on hundreds and eventually thousands of internationally traded securities in somewhat the same way that NASDAQ displays the inside quotations on 4,750 domestically traded securities in the United States.

The vendors are betting that there will be a rapidly growing market for international quotation information. This is shown by the fact that AP, Dow Jones and Quotron, the largest domestic vendors, have launched a joint venture in Europe. AP, Dow Jones and Telerate, the large British vendor, have set up another joint venture. GEMCO, the newly announced joint venture of Citibank N.A. and McGraw-Hill, though focusing on commodities initially, is a potential player in the equities area.

The activities of the market data vendors and their securities firm subscribers will inevitably have a synergistic effect on the markets. There will be increasing pressure on the markets -- London, NASDAQ, the continental European markets and very importantly, Tokyo, the second largest market in the world -- to make ever more quotation information available to each other and to the vendors and their subscribers. A global NASDAQ-type price quotation network will be the first technological building block of the global stock market.

As the quotation network grows, actual trading information will follow. NASDAQ was originally only a quotation information system; today it receives and transmits last-sale information on more than 2,200 NASDAQ National Market System securities. The same development may be expected to follow in linked international markets.

The utilization of the global network for the execution of transactions will probably develop also -- but more slowly.

Reuters today offers execution services in a joint venture with Instinet. However, if the domestic experience of NASDAQ with its Small Order Execution System (SOES) is any guide, firms will prefer to execute orders by telephone until their volume of business and the economics of such dictate otherwise. This is particularly likely to be the case internationally, because firms may very well prefer, in the early stages, to use the telephone contact as a means of building close professional relationships from country to country.

In the clearance and settlement area, international linkages can be expected to develop more rapidly. Clearance and settlement represent such a large part of securities firms' trading costs that the firms will put pressure on the markets to bring those costs down.

A good example of what has already happened in his area has been provided by the Canadian Depository for Securities (CDS), the clearing house for the Toronto and Montreal Stock Exchanges, in its recent comment letter to the SEC. CDS became a participant in the Depository Trust Company (DTC) in New York in 1981 and a member of the National Securities Clearing Corporation (NSCC) in New York in 1984. The linkage between CDS and New York is a sponsored-account relationship, i.e., CDS sponsors Canadian participants for their separate accounts in NSCC/DTC. An omnibus account relationship, which may be preferable because CDS would become the agent for its participants at NSCC/DTC, is being explored, as are hybrid sponsored account omnibus account relationships. More recently, NSCC has announced the

establishment of an international securities clearing subsidiary to support domestic firms through bilateral linkages with central clearing and depository organizations abroad. The initial linkage, contemplated with The Stock Exchange in London, may become operational by the summer of 1986. This may very well be a model for future clearing linkages.

On the other side of the globe, the Japan Securities Clearing Corporation (JSCC) has established a business relationship with SICOVAM, the French central depository and clearing agent. JSCC is also in the process of establishing a similar relationship with NAME, the Dutch depository and clearing agent. As the London Stock Exchange-NASDAQ linkage develops, a relationship between TALISMAN, London's clearing system, and NSCC is expected to follow. A worldwide network of clearance and settlement arrangements will come about in due time. Utilization of existing industry organizations such as NSCC and DTC as interface mechanisms for domestic broker/dealers should provide the United States with a major cost advantage.

The international clearance and settlement network will necessarily involve the establishment of rules and procedures in such areas as eligibility standards for participating securities firms; eligibility standards for securities; trade reporting and confirmation; settlement at multiple depositories; and currency exchange rules. The requirements of clearance and settlement processes will help to create much of the regulatory framework for the world market for growth stocks.

From the NASDAQ perspective, all these developments offer opportunities, not only for the big multi-national issuers, the major securities firms and powerful financial institutions, but also for service to a global universe of growth companies, a highly diversified universe of investors, and to the economic growth of many countries.

We see two kinds of organizations servicing the global market for equities -- private vendors, both domestic and international on the one hand, and user-controlled market service systems like NASDAQ, the exchanges and NSCC on the other. Individual vendors already provide quotations and market data worldwide and have the potential to provide many other services. Among these are network linkage services between clearing organizations and depositories and order routing both within market centers and between market centers. No doubt the innovativeness of the vendors will lead to many others.

At NASDAQ, our systems people are exploring new technologies for marketplace efficiency and reliability. Small, two-way satellite dishes offer the potential for more reliable service over wider geographical areas at less cost than the expensive, private land lines. Local computer networking to improve processing efficiency and interfaces for new types of terminals are undergoing research and development. Furthermore, NASDAQ is virtually doubling its single-day capacity and it is building the international securities industry's first complete back-up market support system, to assure the uninterrupted operation of the world's third-largest and fastest-growing equity market.

We are beginning to see the shape of the world market for equities. Market center-to-market center linkages will share up-to-the-second price and trade information and thus provide the basic data for decentralized trading. Dissemination of this information to the worldwide investor community will be vital to market depth and liquidity. Surveillance and regulation in the market centers will be facilitated by these linkages and information flows. Networks parallel to this structure will link clearing and depository information and inject essential foreign exchange information into the whole system.

Multiple trading locations, multiple clearing and depository locations, multiple currency settlement facilities and multiple cooperating self-regulatory organizations will be the principal building blocks of the world market for equities.

Regulatory Structure for International Markets

The volume and pattern of international securities dealings that has developed and the experience to date demonstrates that considerable benefit and advantage can be gained by permitting foreign operations being undertaken in today's marketplaces to mature further. Even now substantial foreign demand for domestic securities is being satisfied by the evolving market structure. Foreign reaction to premature or unnecessary American regulatory initiatives could easily stifle that demand.

Significant competitive inducements exist to encourage foreign cooperation and growth in trading opportunities through communications technology, existing international market forces and the innovation of domestic securities markets and information vendors in dealing with the international markets.

In this regard, the NASD believes that Congress and the SEC should exercise restraint in considering any proposals for applying formalized structure to the international marketplace, such as suggestions for a uniform system of consolidated quotations and transaction reporting or formalized market linkages of the nature currently in use in domestic markets. These concepts are unique to the American marketplace and may be counter-productive in terms of their appearance as an attempt at regimented integration of foreign and U.S. markets. The NASD believes that during this evolutionary period of the international marketplace, concentration upon the control of foreign markets and the practices unique to each may tend to restrain rather than enhance international cooperation and development of competitively motivated market interaction. It would be more appropriate to emphasize the need to encourage trading among international markets and linkages between clearing and settlement systems in order to provide the experience and economic incentive necessary to foster the expansion of trading opportunities. This approach provides a climate for cooperative regulatory initiatives which can be accepted in foreign jurisdictions without undue disruption to existing trading patterns or negative reactions by foreign governments or their regulatory bodies.

During the near term, we should recognize the law applicable in foreign jurisdictions until changed, thus avoiding the impression that American law and securities market structures are the only ones appropriate for universal application.

Congress and the SEC should consider the needs of the diverse international financial interests which will be represented in the international marketplace. This consideration should include recognition of the regulatory approach of other countries under a scheme of continuing review which may prompt an evolution of foreign markets to the acceptance of certain of our laws, where appropriate. Also important in this regard, is a careful and objective reappraisal of all aspects of domestic securities laws applicable to foreign transactions to assure they do not constitute barriers to the development of an international marketplace. Concurrently, the laws and practices of foreign countries should be reviewed to identify foreign barriers to entry and competition by our markets, and steps should be initiated to seek removal of those barriers.

In sum, the NASD believes that the proper approach to regulation of international markets is to monitor developments in the international marketplace and to pool information to assure the development of appropriate regulatory initiatives if warranted. As these markets develop, regulatory and surveillance programs will necessarily form an integral part of planning by the self-regulatory organizations, which can be provided through cooperative undertakings with comparable organizations abroad. As experience is gained with linkages, refinements can be made to

The **Chairman**. Thank you, Mr. Macklin.
Mr. Calvin.

STATEMENT OF DONALD L. CALVIN, EXECUTIVE VICE PRESIDENT, NEW YORK STOCK EXCHANGE

Mr. **Calvin**. Thank you, Mr. Chairman.

I am pleased to be here this morning to present the views of the New York Stock Exchange. I want to commend you, Senator, for calling these hearings because, No. 1, they certainly are most timely; and it is extremely important that people become increasingly aware of the fact that these markets that once were national are becoming international.

I think Senator Proxmire's summary was excellent, and I would subscribe to everything he said in that six-point summary. Those are the type of developments that are occurring.

I think also the concerns that Senator D'Amato expressed in his remarks earlier about tipping the balance, going from one extreme to another and disadvantaging domestic investors in the process, is also a problem we have to be aware of.

These developments are new. They are sweeping. They are changing the ground rules as we sit here, and the changes will not only continue but continue at an increasingly rapid pace.

I think what you have heard from these gentlemen, all of whom are acknowledged experts, and what you will hear from our British colleagues later in the morning will make that point as clear as it could possibly be made.

So I think the hearings are both timely and extremely important.

TWOFOLD CHALLENGE

People like to talk about problems. I think here we have some real opportunities—rather than problems—at this point in time, and the challenges we have are twofold.

The first is to make these international markets open, competitive, efficient, and adequately regulated. Without some intervention I don't see the latter really occurring because people generally don't like regulation. So there will have to be some intervention on somebody's part.

And at the same time, there are additional step we need to take as Americans to keep our preeminent position in the world's financial and investment markets. It is this second requirement that is what I am going to talk to briefly this morning.

Obviously, it is not something any one group can do by itself. It requires cooperation and efforts on the part of not only investment professionals, but certainly on the part of the Government, the regulators in the Government, the accounting profession, the legal profession, and the other people who have an interest in this area, including the stock exchanges.

And what we must do is really reassess our competitive and regulatory environment in light of these new developments. The type of markets we have here are not typical of what you find outside the United States in terms of regulation and in terms of their state of development.

On the other hand, these international markets are increasingly more active. They are growing in size, and the participants are among the most important participants in the world.

A lot of the activity that you are hearing about, as by Mr. Weatherstone mentioned, originates with the U.S. firms. So it is not just something people outside the United States are doing. We are active participants. Our firms are active participants.

Today, their principal customers are institutions. They are the so-called sophisticated investors who are really fueling this activity. In the competitive world in which the firms must live, they are simply seeking the best value for their customers and for themselves; and you can't fault them for that.

The volume of these transactions is increasing, and we are benefiting by it. For example, last year about 10 percent of the transactions on the New York Stock Exchange originated abroad. Since last year was a record year for us in terms of dollar volume and share volume, that 10 percent is greater than it would have been a year before.

But when you look at other markets, that percentage of increase pales by comparison. One example would be Germany's Frankfurt Stock Exchange, where the volume last year was up 70 percent. Ours was up about 19 percent. But 50 percent of the participation in the Frankfurt market was from outside Germany, much of it from United States investors who were seeking better value for their investment.

The U.S. sophisticated investors include, obviously, the pension funds. They have increased their participation in the foreign markets, and we are among the first to do so. Some now have about 7 to 8 percent of their funds in foreign investments.

And that affects all of us because all of us are in one way or another a participant in a pension plan. So while we may not be doing it directly, it is being done for us indirectly by our professional money managers.

I am sure you know that some 10 percent of the U.S. Federal debt instruments are foreign owned. The largest U.S. Government bond market in the world is, of course, in New York. The second largest is not Chicago. It is not San Francisco. It is not Los Angeles. It is Tokyo. Tokyo is the second largest U.S. Government bond market in the world.

So if this scenario continues, the activity will obviously continue; and the challenges, if you will, will also continue. So will our opportunities. Foreign investment is not limited to professionals; the number of U.S. mutual funds specializing in global or foreign investment has grown from about 20 two years ago to 41 last year—nearly a 100-percent increase.

GREATER RETURNS ON INVESTMENTS

And if you wonder why, look at the returns that they have received. If you had invested in a mutual fund holding stock in U.S. companies only, your return, on the average, would have been 28 percent. If you invested in one of these 105 global funds that are out there, it would have been 41 percent. If you bought shares in one that was invested in United Kingdom securities only, you got a

47-percent return. If you invested in one that invested in Swiss securities only a 98-percent return; and in Germany securities, 111 percent.

I am sorry I didn't do it, frankly; but when it comes to investing their own money, people who are doing this know more about what is happening to stock prices than we who manage the exchanges.

Among the major international investment firms, Nomura Securities has been mentioned already. Nomura is a tremendous organization. They are fantastic. Those people are dedicated. They are worldwide in their vision. They are the largest investment firm in Japan, where they have tremendous competition domestically from Daiwa, Nikko, and Yamamichi Securities, among others. Nomura is the largest investment firm in the world. Their shareholder equity, $2.8 billion, exceeds that of Merrill Lynch by about half a billion dollars currently. They have offices around the world, and they are looking to foreign activity to account for more than half of their income in the next few years.

Their view is international, as it is with Daiwa, Nikko, and Yamamichi. They are like the Japanese auto companies were a few years back. They have saturated the local market, and now they need to look overseas for their profitability.

And, as I am sure you know, that is exactly what happened to Toyota not too many years ago, when the profitability lines crossed; their international business exceeded their domestic business. Today their domestic business is not profitable, but their international business sustains them.

I think that is the same view these major investment firms are taking, and they are doing a beautiful job at it.

The American firms are not far behind. Merrill Lynch has more offices abroad than does Nomura today. They operate in 30 countries with 74 offices.

Goldman Sachs has been a leader in this activity, as have Salomon Bros., Morgan Stanley, First Boston, and other leading U.S. firms, both large and small. It is not limited to the large U.S. firms.

At the same time, the U.S. issuers of securities are going abroad, something that would have been unbelievable a few years ago.

Bob Hormats mentioned that last year there were 14 United States companies that got their equity financing in the United Kingdom. There are at least five that we are aware of that have not gone public in the United States, but made initial public offerings, or IPO's in the United Kingdom. They did so because they could do so more cheaply, they didn't have to submit to SEC regulation, and the process was less costly to them. I am sure they are very well satisfied with the $29 million that they raised in the United Kingdom to finance their capital expansion.

As Dennis Weatherstone has said, the Eurobond and Euroyen financing is growing at a phenomenal pace, so much so that, for example, in October of 1985, U.S. issuers raised more capital in the European Eurobond market than they did in the U.S. domestic market, which is probably the first time that happened.

So the people who are using these markets are the major American issuers; it is not just somebody out there that we have never heard of. And, as my prepared statement says, there has been tremendous growth in that market.

As I think Senator Proxmire and you, Mr. Chairman, correctly said it at the outset, these are not passing events. So what is going to happen as these markets grow?

While we have viewed our markets from a national standpoint, we need to look at these markets from an international standpoint. So our focus has to be entirely different from what it was in the past when the type of structures and regulation we have today was developed.

We have a lot of requirements in the United States that don't exist anywhere else. And you have to wonder; either we are a lot smarter than everybody else or else we are different because we want to be different. Will these other people conform to our requirements? Probably the answer is no, they won't.

One of those requirements is the New York Stock Exchange's requirement on quarterly reporting. The SEC has no such requirement. There is no other exchange in the world--no other market in the world—that requires quarterly financial reporting.

That immediately becomes a problem if you want to get a foreign issuer to come into the United States, which they are increasingly reluctant to do. Obviously, we need to do something in that area.

POSSIBLE STRUCTURAL CHANGES

Similarly, our financial and accounting requirements in many respects go way beyond that of any other country. In some countries the cultural differences are such that secrecy laws are a way of life there.

I remember testifying before Senator Proxmire on this a few years ago during hearings on the Foreign Bank Secrecy Act. You run into cultural differences. Their attitude is different. Honorable people from those cultural environments don't see anything wrong with greater privacy in their financial matters. We obviously are an open society and have different requirements.

There has to be an accommodation somewhere in between if we are going to expect these people to do their financing here.

In administrative things like clearance and settlement, there are wide discrepancies; in some cases it is done by cash in 1 day, in other cases it takes a month or more.

We have requirements with respect to short selling, which are uniquely American. An American firm that doesn't want to comply with that type of regulation and doesn't see the merit in doing so, can make the same transaction outside the United States and not have to comply.

There are tremendous differences in the requirements in prospectuses. In the United Kingdom, for example, the prospectus is much briefer. They focus on future activity rather than past performance, which we do not. A lot of people think that system is a very good one, perhaps not a better one than we have. The fact that increasing numbers of Americans are investing in United Kingdom companies shows they feel they are getting an adequate amount of information to make an informed investment decision.

Here is what seems to be happening. Because of competitive considerations, in part, trading is attracted to the less regulated environment; we, on the other hand, have the most regulated environment.

At the New York Stock Exchange, we have been doing a number of things. For example, we have opened our market a half hour earlier. We are talking about developing systems which could accommodate auction-type trading for a more extended period of time without requiring people to be physically present on a trading floor.

We are exploring ventures, cooperative and joint ventures, with the London Stock Exchange. At the appropriate time, I would like to offer a recent news release, Mr. Chairman, that was issued by the New York and London Stock Exchanges, talking about an experimental cooperative trading system that we hope to finalize within the next month or so, which is step in the direction of an important cooperative activity.

I'd like to submit that for the record.

The CHAIRMAN. We'd be happy to place it in the record.

Mr. CALVIN. At the same time, and I'll come to this later, we also issued a press release which talked a little bit about what we may be required to do under British law in becoming a recognized investment exchange in the United Kingdom

And I'd like to offer that for the record as well, the second release of February 11.

[The following information was subsequently supplied for the record:]

News

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For Release Immediately
Tuesday
February 11, 1986

NEW YORK STOCK EXCHANGE SERIOUSLY CONSIDERING PLAN TO BECOME "RECOGNIZED INVESTMENT EXCHANGE" UNDER PROPOSED BRITISH LAW

Also Exploring Plan to Become Self-Regulatory Organization in U.K.

NEW YORK, Feb. 11 -- The New York Stock Exchange is seriously considering a proposal to be designated a "recognized investment exchange" (RIE) under the financial services bill pending before the British Parliament, John J. Phelan Jr., chairman and chief executive officer, said today.

"In addition, we are exploring suggestions to be named a self-regulatory organization (SRO) in the United Kingdom," Mr. Phelan said.

Simultaneously, he said, discussions are continuing with other foreign exchanges and market information vendors concerning possible links and arrangements.

Mr. Phelan said a variety of issues remain to be explored, from pending and current British laws to competitive conditions, before a specific RIE or SRO plan could be presented to the NYSE board of directors.

He set no timetable on completing the examination of the proposals.

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Depending upon the final form of the financial services bill, designation of the NYSE as an RIE would enable NYSE members in the U.K. to continue to execute securities transactions directly on the NYSE, without separate approval by British authorities.

Similarly, becoming an SRO under British law would enable the NYSE to conduct regulation and surveillance of member firms in the U.K.

"We have a responsibility to investors and our members to ensure we continue to provide the world's premier securities marketplace," he said.

"Thus we regularly review market conditions and ideas worldwide in an effort to continually improve our service."

"The proposal for our formal entry into the British financial system is one such idea, which we are exploring in detail."

The NYSE also is examining its regulatory role in light of various international developements, Mr. Phelan said.

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For Release: Immediately
Tuesday
February 11, 1986

NEW YORK AND LONDON STOCK EXCHANGES NEAR AGREEMENT ON EXPERIMENTAL COOPERATIVE TRADING SYSTEM

Arrangement Possible by April

NEW YORK, Feb. 11 -- The New York Stock Exchange and the London Stock Exchange hope to reach agreement by April to initiate a plan for an experimental cooperative trading system involving a limited number of stocks in the two marketplaces.

"As a result of discussions over the past seven months considerable progress has been made toward the development of an international linkage between the two exchanges in a limited number of listed British and American stocks," said John J. Phelan Jr., chairman and chief executive officer of the NYSE, and Sir Nicholas Goodison, chairman of the LSE.

"The proposed system could be the first major step in the evolutionary development of a global trading system within the framework provided by the world's leading stock exchanges," Messrs. Phelan and Goodison said.

"As a result, investors would benefit from the self-regulatory surveillance and oversight of the exchanges in stocks of major international companies in the different time zones," they said.

-more-

The details of the pilot program are being worked out.

The two exchanges have also made progress in other areas including the sharing of regulatory information and market data.

The discussions between the two exchanges are continuing through a joint task force of the two exchanges which was named last June.

The NYSE is represented by Donald L. Calvin, executive vice president, and Christopher Keith, senior vice president, and the LSE by Jeffrey Knight, chief executive, and George Hayter, director of information services.

# # # #

Mr. Calvin. We have similar discussions ongoing with the Amsterdam Exchange and the Tokyo Exchange. We're going back to Tokyo again next month. The Japanese are quite interested in entering this market, but they have problems with quarterly reporting and financial segment reporting.

On the prospectus front, the SEC has taken a very constructive action by proposing a reciprocal arrangement with the United Kingdom and Canada, where one might accept the prospectus used in the other country and then add on additional information that was unique to the local requirements.

But I think the remarks of Senator D'Amato need to be emphasized, that is, whatever is done here, we have to continue to protect the interests of U.S. investors, particularly an individual investor. We've got to provide adequate service.

From the standpoint of the New York Stock Exchange, we feel it's important to continue the type of pricing system that we have in our public auction market.

We have also formed a European advisory committee of some 15 leading European industrialists. It's chaired by Sergio Orlandini, of Amsterdam who is the CEO of KLM Royal Dutch Airlines.

We've formed an international division, and we have launched a review of our own regulations. We have drawn on the expertise of our legal advisory committee; our international capital markets advisory committee, of which Dennis Weatherstone is a member; and our global trading committee, which is chaired by Bob Freeman of Goldman-Sachs.

We think similar actions need to be taken by the appropriate Government agencies, both State and Federal, by the other U.S. markets, by other financial institutions and by the legal and accounting professions.

In my prepared statement, I address significant changes occurring in the United Kingdom; I'm sure you'll hear more about this later this morning in the second panel.

There are also significant important changes occurring in Japan; they have opened up the Tokyo Stock Exchange to foreign members. The Tokyo Stock Exchange itself will open an office in New York this spring. They have embarked on a program of listing the 200 to 300 world class companies in Tokyo. And as a part of that program last year, they increased the number of U.S. companies listed on the Tokyo Stock Exchange by more than 100 percent, from 10 to 22 in 1 year.

Some people think that Japan, and Tokyo in particular, will become the financial center of the world in the future; and that very well may be their intention.

In summary, there are a lot of challenges out there, Mr. Chairman. Your hearings are timely. It's something that needs to be pursued, and I don't think it's the type of development that we can just watch, I think we have to get involved and exercise the leadership position to see that these objectives that I mentioned at the outset are achieved.

Thank you very much.

[The complete prepared statement follows:]

these regulatory surveillance programs consistent with any identified need, with the self-regulatory organizations working in concert with the SEC.

Thank you for the opportunity to present these views of the NASD. If members of the Committee or staff have any questions, we will be happy to address them.

HDA:Testimony

TESTIMONY BEFORE
THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
THE UNITED STATES SENATE
WASHINGTON, D.C.
FEBRUARY 26, 1986

"EMERGING GLOBAL MARKETS:
CHALLENGES AND OPPORTUNITIES IN THE U.S. SECURITIES MARKETS"
DONALD L. CALVIN
EXECUTIVE VICE PRESIDENT
NEW YORK STOCK EXCHANGE

SUMMARY

International markets for the issuing and trading of stocks, bonds and other securities have emerged and are continuing to expand. This represents both a challenge and a great opportunity for the securities industry in this country. Whether these international markets will be open, competitive, efficient and properly regulated may well depend on how promptly and how effectively we contribute to development of an appropriate framework.

Investment professionals, the managements of exchanges and regulators need to join forces to insure American markets are able to maintain their competitive edge while fostering order, efficiency and adequate protection for investors in these international securities markets.

In this country, we have a great body of knowledge and experience in the regulation of a well-established, robust and rapidly growing securities industry. It requires the efforts of thousands of talented people. But there are few experts to cope with the lack of regulation in other countries and even fewer organizations with the capabilities to oversee international trading of securities.

Round-the-world, round-the-clock trading has arrived. And it has been growing at an ever-increasing rate for years. The prime movers have been major U.S., Japanese, and British broker-dealers and their institutional investors as well as foreign and international banks.

Quite properly, they have been shopping where they get the most for their money. Last year, some 10% of the transactions on the New York Stock Exchange originated abroad. On the Frankfurt, Germany, exchange about 50% of the business was foreign, much of it from U.S. investors. Many innovative people and organizations are developing their own methods of handling this business, but in an unplanned and barely regulated way.

If the U.S. economy continues to expand, interest rates continue to decline, and inflation does not get out of control, there should be a strong market for financial assets in general -- and for equities in particular. This would create problems for U.S. participants in international capital markets that will involve regulators, lawyers, accountants, exchanges, and U.S. investment firms.

The New York Stock Exchange is addressing this issue in its own arena. It has formed a European Advisory Council of prominent foreign executives and has formed an International Division within the Exchange. It is also making extensive use of existing committees such as its International Capital Markets and Legal Advisory Committees and its Global Trading Committee to provide expert advice in developing proposals on measures the Exchange might take. A Market Regulation Review Committee has recently been formed by the Exchange to review all of its market regulations. Other parties who make up the securities industry such as federal and state agencies, other exchanges, and investment firms should take similar steps.

There is a need for immediate action on two related but distinct matters. One is a national effort to make the U.S. marketplace attractive to international trading in securities. The other is an international effort to develop an efficient, orderly, openly competitive and adequately regulated international securities market.

The expansion of international trading in securities will not stop. In 1983, there were some 20 American mutual funds specializing in global or foreign stocks. Last year there were 41.

Nomura Securities and its subsidiary Nomura Securities International, the world's largest brokerage firm with seats on both the Tokyo and New York Stock Exchanges, earns 25% of its revenues from international business and expects that to grow to 50%. Outside Japan, Nomura has offices in 24 cities around the world. Merrill Lynch, Pierce, Fenner & Smith, Inc. has 74 institutional and retail offices in some 30 countries other than the United States.

The New York Stock Exchange is exploring cooperative ventures with with our English, Dutch and Japanese counterparts. Other exchanges around the world are also working on individual arrangements for information flow, trading or clearance arrangements.

If prompt action is not taken, the U.S. could lose its leadership in the financial services industry to less regulated foreign markets that show greater innovation and responsiveness.

Mr. Chairman and members of the Committee:

My name is Donald L. Calvin. I am an executive vice president of the New York Stock Exchange.

I welcome this opportunity to provide our views on the international market in securities, particularly its impact on regulatory matters and what can be done to help create an efficient system with proper oversight.

Investment professionals, regulators and the managements of exchanges need to join forces to insure fair and open competition while supporting order, efficiency and proper oversight in international trading.

Next year the country will be celebrating the 200th anniversary of the signing of the Constitution of the United States. Five years later, the New York Stock Exchange will be celebrating the 200th anniversary of its founding, the signing of the Buttonwood Agreement.

When 24 gentlemen met under a Buttonwood Tree near the present site of the Exchange and signed an agreement in 1792, they established some regulations to govern their trading with each other.

The New York Stock Exchange and our financial institutions have grown along with the nation to a preeminent world position. But, with changing markets and new players, all of us will have to compete even harder to stay on top.

Today we need to emulate the foresight and wisdom of those 24 men because we are on the verge of another great evolutionary development. We will start our third century with a large, active international securities marketplace. That much seems clear.

Whether it will be efficient, open, competitive and properly regulated may well depend on how promptly and how effectively we develop a framework for markets that are already emerging. It is in this sense that we all have a big role to play in deciding whether the securities industry in this country remains the world leader or whether we follow the route of some manufacturing industries that have seen large shares of their business move overseas.

In this country, we have a great body of knowledge and experience in the regulation of a well-established, robust and rapidly growing securities industry. Just developing and administering the regulations that guide the financial services markets here takes thousands of talented people.

Contrast this with the capabilities we have to regulate international trading of securities and the lack of regulation in other countries. There are few experts and even fewer organizations to exercise oversight.

But the stark fact is that, while we were thinking about it, round-the-world, round-the-clock trading arrived. And it has been growing at an ever-increasing rate in an unplanned and barely regulated way for years.

In addition to foreign and international banks, prime movers have been major U.S., Japanese, and British broker dealers. And their customers, up to this time, have been principally institutions. These institutions have been doing exactly what they should do. They have been shopping where they get the most for their money. And money leaks through, and flows around, national boundaries and regulatory barriers much more easily than manufactured goods can.

There are many examples, of which I shall cite just a few.

Last year, about 10% of the transactions on the Big Board originated abroad. No doubt that additional business helped push our dollar volume of stock traded in 1985 up nearly 27% to $970 billion.

But we can look, for example, at the smaller Frankfurt, Germany, stock exchange where last year 50% of the business was foreign money; and volume was up over 70%. Much of that foreign money was from U.S. investors.

Some major U.S. companies have 7% to 8% of their pension funds in foreign investments.

Today, about 10% of our federal debt instruments are foreign-owned. The biggest market for U.S. Government securities outside New York is not Chicago, San Francisco, or Los Angeles. It is Tokyo, where the Japanese are helping to finance U.S. debt -- over $20 billion in the last three years, most of it last year.

I would like to give you a view of what we see taking place from the perspective of the New York Stock Exchange.

We are in the beginnings of a decade of equity financing. Money from real estate and tangibles is starting to flow into stocks and stock mutual funds. Whose stocks? In automotives, it might be GM or BMW. In electronics, it might be Texas Instruments or Toshiba. In chocolate, it might be Hershey or Nestle.

In 1983 there were some 20 U.S. mutual funds specializing in global or foreign regional stocks. In 1984, it was up to 31. Last year there were 41.

Lipper Analytical Securities Corporation compiles data on the performance of key domestic and foreign funds. Their data for 1985 helps explain the attractiveness of some foreign investments. While the 56 funds that invest in only U.S. securities rose an average of 28%, 105 global funds invested in many different countries averaged a 41% increase. Some funds concentrating on investments in specific countries did even better. The sixteen in the United Kingdom rose 47%, the five in Switzerland rose 98%, and Germany's three rose 111%.

Nomura Securities and its subsidiary Nomura Securities International Inc., Japanese firm, is also a member of the New York Stock Exchange. Nomura, whose $2.8 billion in shareholder equity is larger than Merrill Lynch's, earns 25% of its revenues from international business. It expects that may grow to 50%. Outside

Japan, it operates offices in 24 cities around the world, including six in North America and eight in Europe. Merrill Lynch, Pierce, Fenner & Smith, Inc. operates 74 offices for institutional and retail customers in some 30 countries other than the U.S..

In the UK, a market for initial public offerings of stock from small U.S companies is opening up. Since September of last year, five U.S. firms that remain privately held in this country have made initial public offerings totaling $29 million in London, thus raising the possibility of regulatory complications as well.

Eurobond and Euroyen financing of companies worldwide is growing, and U.S. issuers are principal users. The amount of Eurodollar bonds and notes issued by non-U.S. entities rose from $15.8 billion in 1981 to $40.4 billion in 1984. On the other hand, the amount of bonds issued by foreign entities in the United States fell 30%, from $7.2 billion in 1981 to $5 billion in 1984.

U.S. firms are also turning from the United States to the Euromarket to float new securities. The 1981 Eurobond issues by U.S. corporations totaled $5.7 billion; by 1984, that had more than tripled to $18.7 billion. In 1984 alone, these Eurobond issues by U.S. corporations came to 35% of the volume of bonds that U.S. corporations issued in our domestic markets.

Throughout the world, we see more and more evidence of expanding overseas securities markets.

If the U.S. economy continues to expand, interest rates continue to decline, and inflation does not get out of control, the long-term prospect is that there will be a strong market for financial assets in general -- and for equity securities in particular.

If this scenario is even roughly correct, U.S. participants in international capital markets will have problems. With major U.S. companies going offshore for equities as well as debt, and easier, less stringent markets cropping up abroad to handle the business, we are all drawn into the dilemma -- regulators, lawyers, accountants, exchanges, and U.S. investment firms.

While the financial services environment has become international, the legal, regulatory and market structures are still national. We could start with some relatively simple examples in the area of disclosure.

The New York Stock Exchange requires quarterly reporting to share holders. But the Japanese, for example, are on a semiannual reporting basis. Talking to the Japanese or Europeans about changing to quarterly disclosure is like talking to U.S. firms about going to monthly reporting. But they all might agree to some type of interim financial update between semiannual disclosures.

On the other hand, convincing U.S. investors -- not to mention government officials, analysts, journalists and regulators -- to go from four to just two reports a year will be equally difficult. Yet

I believe we have to give serious consideration to recognizing the home country practices in this area and others.

For example, we require complete audits and financial disclosure. But many other countries, because of cultural differences and competitive practices, have secrecy laws. Those laws protecting individuals from involuntary disclosure are part of the political, social and cultural heritage in many countries.

We require disclosure of U.S. company officers' compensation, but other countries do not -- some because sizeable perquisites are difficult to quantify uniformly and others because disclosure of compensation makes executives and their families targets for criminal elements.

Other interesting contrasts can be found in clearance and settlement procedures. In the United States, we have a five-day rule. In other countries, it varies from one-day cash settlement to 30 days or more. Modifying systems in a significant way will certainly be costly as well as difficult.

Add to this our detailed regulatory requirements on short selling, that is, the accepted practice of selling securities that you do not own. Such rules do not exist in other countries. Some traders are finding it attractive to go to London or elsewhere to trade securities to avoid these regulations. This has led some people to suggest that our short sell rules are antiquated and should be

modified to deal with the potential abuses, but in a more relevant way for today's markets.

Practices also vary on the matter of a prospectus. In London, the typical prospectus for an initial public offering is different from one for an identical offering in the U.S. -- much shorter than ours and focused on future, rather than past, performance. Yet a good many foreign investors have no trouble investing in British firms and feel a British prospectus offers enough information for a sound decision.

This brief list hardly scratches the surface, but it makes the point that critical regulatory elements of international markets do not mesh.

There's a terrible irony in all this. I have made trading across national boundaries sound almost impossible. Yet it is happening every day, and with increasing frequency. And, like typical pioneers, those doing it have found their own routes around the barriers without waiting for any grand design.

Securities markets, like most other markets, tend to develop in the most favorable regulatory environment, that is, the market with the least regulatory requirements and impediments. Regulation has a cost which must be borne by the user of the market. With greater competition, the costs of regulation may mean the difference between a profitable transaction and a loss. Thus, the greater competition

The **Chairman**. Thank you, Mr. Calvin.

Each of you have testified that the trend to international marketplace is inevitable. I would certainly agree with that. It's been rather dramatic, as each of you have pointed out. I believe there are obvious risks to the U.S. marketplace as a result of this change, particularly in the regulatory environment you have talked about, Mr. Calvin, and if our regulatory structure does not respond fully to these changes.

I'd like each of you, just in a general sense, to give the committee any recommendations you might have in this area, what we might do in our regulatory structure so that we do not injure our own market.

Mr. Weatherstone, do you have any recommendations for the committee?

Mr. **Weatherstone**. Mr. Chairman, first of all, I'd like to repeat the pleasure I have in being here and listening to all the panel members and finding really a good degree of agreement about the way the market is going, and the importance of the U.S. regulatory system being a positive factor rather than a hindrance.

I think we certainly want to avoid any allegations of a competition in laxity, which might be directed at us.

As regards specific issues, in my statement I did point out one factor that I thought was a problem, and that is the hindrance of the Glass-Steagall Act, in that the commercial banks do participate very fully in the international markets outside the United States, and believe they could serve a useful purpose within the United States if there were appropriate changes made there.

So that's the only actual positive suggestion I have to make.

The **Chairman**. Mr. Hormats.

Mr. **Hormats**. I think there are a number. A number of the points that Mr. Calvin pointed to with respect to the encumbrances on new issues in the present U.S. problems.

LESS REGULATION WITH CONTINUED PROTECTION

We need to take a pretty careful look at the right balance between less regulation and continued protection of the investor. And that is a difficult line to identify in some cases.

But let me just make a couple of general points on where I think we ought to be looking.

First, there are a whole range of reporting requirements that are imposed upon a potential issuer in this country. Some are by the SEC, others, quarterly reporting, for instance, by the Exchange itself.

There is a very rigorous rating process in this country, which is not done in any other market in the world. An issuer to commercial paper has to get a rating; certain types of private placements do likewise, one is to sell them to certain types of institutions.

You have to get a rating to do bond issues. There are an array of these requirements. And if there's one hindrance to, or disincentive to a potential issuer in this country, it's the prospect of having to get a rating, which you do not need in the Euromarket. And you need to a much less degree in Japan.

So that's a problem. Now I'm not prepared to say we shouldn't have ratings. Obviously, ratings do protect the investor. But we also have to recognize that a number of issuers say they're not going to use this market because they don't want to go through that process.

The basic point is the need to take a very hard look at each of these impediments, see how they stack up vis-a-vis those in other countries, and then determine whether they are appropriate and necessary in this world environment.

I suspect we'll find that some are. And I think we'll find that some aren't.

And I'd also make the point with respect to competition, we are in, as we've all underscored, a highly competitive world financial market. The choice is not whether we regulate or not. Obviously, there are going to be regulations on financial markets, and that's appropriate.

The real question is whether, if we regulate too much, we will lose the game because companies will issue securities and trade in markets that are unregulated. In that case, the very regulations we impose will be counterproductive to our overall objectives, because so much of the business will go offshore to escape these regulations or avoid them, that, in effect, we will lose the ability to do any regulation at all or lose a considerable amount of that.

I'd also say the question of global efficiency is important here. Our clients want to raise money wherever they can best raise it in the world.

And if we look at all the options, then we would have to say in many circumstances that the Euromarket for issuer X is better than the American market. I mean, we're—and Morgan as well—is really an international firm. And when we try to serve our clients, we must look at all the various alternatives.

If the American market is more cumbersome, then our advice would be look abroad.

And the ultimate objective is to find the most efficient market for the individual issuer. Or, in the case of the individual buyer of securities, we will look around the world to find where they get the best buy.

And that may be the American market. In fact, I think most of us really would hope it is, where we come from; we're American firms. We also have to take a global perspective.

And if our markets don't keep up with those of other countries—if they are overregulated—then the business is going to go abroad.

I'd also say, if it does go abroad, in the final analysis, it wouldn't be particularly good for us because we like to do as much of the business here as possible.

The CHAIRMAN. Mr. Macklin.

Mr. MACKLIN. Well, Mr. Chairman, there obviously doesn't appear to be any quick remedy or quick fix that would address all these problems. We are spending a lot of time, effort, and dollars continuing to explore these opportunities, but we'll give you these thoughts for what they're worth.

ENCOURAGE RESEARCH AND DIALOG

We think it would be good national policy to first encourage more research and dialog on this subject. Gramm-Rudman or not, I think the SEC, among others, could set aside some specifically dedicated resources to learn more about the activities in other markets; and to improve the dialog, as all of us people in the private sector are trying to do.

Second, we'd strongly recommend that, as national policy, we avoid lurching ahead with recommended regulatory solutions to problems that are yet clearly defined, and particularly I think we should avoid putting forth solutions that look to be made Made in America remedies to problems that might exist elsewhere in the world.

Third, we feel that, as a matter of national policy, we should encourage increases in cross the border trading. That would build a base of experience on which to build future regulatory enhancements.

Finally, as we look at the regulatory differences among countries and the barriers, one of the most severe to doing business in this country for foreign companies is the possibility of liability through our court system. It seems that our securities laws and general corporate laws, as amplified and enforced through the courts, bring penalties and risks in some cases far beyond the amount of the transaction to start with.

The liability in our court system is serving to deter many foreign companies from participating in our market.

The CHAIRMAN. Mr. Calvin.

Mr. CALVIN. Mr. Chairman, let me give you three categories where I think action needs to be taken and some of these actions are underway.

The first is with respect to issuers, and we're talking both domestic and foreign, because we don't want to be in a position of doing something that's done for the foreign issuer that disadvantages the U.S. company.

And on that, I think the most important initiative now is the SEC's initiative to try to get other countries to agree to reciprocity in the use of a prospectus for multinational offerings. And I think the SEC really ought to be commended for starting this discussion more than a year ago.

They sent out a release asking for comments on how best to deal with multinational offerings. They got a lot of comments from around the world, literally, that supported the use of a reciprocal prospectus for a multinational offering.

That would benefit the U.S. companies as much as it would benefit the other major international companies that are headquartered outside the United States.

And the SEC's iniative ought to be supported by the Senate as it is already supported by people in the financial community.

For example, our European advisory committee, that I mentioned earlier, has written to the SEC. These are top industrialists, as I said, from about 15 countries throughout Europe. They have written to the SEC announcing their support for the SEC initiatives and offering to assist the SEC wherever they can.

They plan to send a similar letter to the appropriate governmental and regulatory authorities in the European countries from which they come, to urge similar cooperation on their part. So that's No. 1.

No. 2, it's clear that something needs to be done about segment financial reporting.

REASSESS DISCLOSURE REQUIREMENTS

This is a uniquely American requirement. It doesn't exist in any other country in the world in the form and detail that it exists here in the United States. It puts our companies at a disadvantage vis-a-vis their foreign competitors by having to disclose their profitability or their source of income by business lines, that is, by segments.

No other country in the world requires that type of disclosure. The modified segment of reporting, which the SEC adopted a few years ago in form 20F, is a much more reasonable approach and one which international companies can live with. That ought to become more the standard than the current, full segment reporting. I understand the SEC has had a proposal for quarterly segment reporting. Again, we're the only country in the world that does it on an annual basis. There now is a proposal to do it quarterly.

I understand the Commission is going to take up that proposal tomorrow. If that's true, that could run counter to all the type of things that we're talking about here, because you're imposing on U.S. companies and foreign companies that want to enter here even greater burdens than exist anywhere else. And you have to ask this question: Is that the appropriate thing to do in light of what's happening in the world today?

Next, I mentioned briefly and explain in more detail in my statement that we at the New York Stock Exchange are reviewing all of our rules. Many of these regulations where developed to address conditions existing in national markets years ago. They need to be reevaluated in light of international developments, to see whether these requirements are appropriate for conditions today and what's happening out there internationally.

I would urge that the same type of thing be done by the SEC and other regulatory agencies responsible for requirements in this area.

That's important from a number of standpoints. For our firms to be competitive, we have to see to it that the ground rules on which they operate here in the United States don't unduly burden them vis-a-vis their international competitive posture.

If there are requirements—and I'm sure there are some—that were appropriate 40 to 50 years ago when they were adopted but are no longer relevant, they should be modified or repealed.

In a third area, investment funds, I mentioned the growth of global funds. The tragic part that I didn't mention is that U.S. investment companies are not permitted to sell their funds in Europe, nor do we allow the European funds to sell in the United States. There is no reciprocity in that area.

There's a horror story, which many of your staff knew of, about a German fund that tried for 10 or 15 years to get registered in the

United States under the Investment Company Act of 1940. The thing fell apart at the last minute.

That whole area needs to be addressed. I mean, here we have Americans who are putting more and more money into U.S. managed mutual funds that invest abroad; about our U.S. investment companies may not sell their funds in Europe, and the Europeans can't sell here.

There's a recent European Community directive which would establish uniform requirements for investment companies throughout the European community. The Investment Company Institute and others are supporting that initiative because, should it be adopted, it would serve as a basis for accepting European standards in some cases where there's a problem under the U.S. Investment Company Act.

So there are at least those three areas, Mr. Chairman. The point is that these things need to be looked at now in this broader context to see where changes are required. But, definitely, changes are needed in many areas, in my opinion.

The **Chairman**. Thank you, gentlemen.

Senator Proxmire.

Senator **Proxmire**. Mr. Calvin, you painted a very tempting and exciting scenario there. I think a lot of people don't realize that, although we have had a terrific boom market here in the United States, that investment, in foreign securities in 1985 would have been far more profitable.

A 100-PERCENT RETURN IN GERMANY

You gave a whole series of instances, ending up with Germany, as I understand it, where you get about 100 percent return on your dollar in the most recent period.

Is that right?

Mr. **Calvin**. That's right.

Senator **Proxmire**. I think very few people understand that or realize, the opportunity available. And I think that once they do, we're going to get a great deal more of this.

I notice also in the charts that are going to be presented later by the United Kingdom witnesses, the enormous increase in just the last 5 or 6 years in this area has been phenomenal, since 1979.

Let me ask you this. It's my understanding, Mr. Calvin, that market professionals and institutional investors—professionals, then the institutional investors—do the vast majority of international trading.

I'm led to believe that these players will continue to dominate the global markets.

What steps, if any, do you believe should be taken to make it easier for ordinary customers to invest in foreign securities?

Mr. **Calvin**. Well, that is another good question. As I just mentioned, Senator Proxmire, allowing United States investment companies and mutual funds to be sold in Europe and allowing the European and United Kingdom funds to be sold here would facilitate that.

In other words, as an individual, I might be better advised to rely on a professional manager when dealing in German securities than for financial service is forcing both U.S. issuers and financial advisors to do their business increasingly outside the U.S.

Some information and trading links between markets have been worked out on a case-by-case basis. The New York Stock Exchange opens trading a half-hour earlier than it used to, to extend our overlap with the London market. We have been exploring cooperative ventures with our English, Dutch and Japanese counterparts and our American firms in Europe and the Pacific Basin. We are also looking at means to exercise more effective oversight on our member firms' activities in the London and other overseas markets.

And on a recent trip to Tokyo, our chairman, John J. Phelan, Jr., and I had useful discussions with officials at the Ministry of Finance, the Tokyo Stock Exchange and the Kiedandren -- the organization of leading Japanese corporations and business executives. Among other things, we looked at possibilities of dealing with the problems of segment and quarterly financial reporting, uniquely American practices.

We are not going to hit on a perfectly clean solution every time. If we cannot have a common prospectus, for example, we might agree to accept each others' on a reciprocal basis or get as close as possible and then put a warning label on the cover stating that disclosure practices are different.

If the New York Stock Exchange cannot operate with full trading floor services 24 hours a day, we may have to consider possibilities like electronic reporting facilities for off-hour trading. The facility would have to provide adequate protection to the individual investor and around-the-clock service for institutional investors and also maintain the basics of the public auction market that has served us so well.

As the markets for securities of U.S.-based companies become more international, it would become increasingly difficult to provide the level of surveillance we have become used to. For instance, a recent article noted that R. J. Reynolds has had its stock listed in London, Geneva, Zurich, and Amsterdam. And they are reportedly pursuing listings on five more exchanges, including Tokyo. They are not alone in this.

This trend is not part of something we planned or created, or something we are even ready to regulate in a meaningful way. The question is how do you keep American markets competitive and attractive while still keeping an eye on what is happening to hundreds of American corporations whose stock may be actively traded outside the U.S.?

Furthermore, while corporations in need of financing are listing on various exchanges, trading firms are passing their books from one international office to another and trading around the world almost continuously. How will our reporting requirements handle this without reducing our competitiveness?

To get in a position to answer that question and others like it, we have to move forward simultaneously on two related but distinct efforts, one national and the other international.

At the national level, we have to reassess what is necessary to make ourselves attractive to foreign business. Times have changed since we laid the foundation of our regulatory structure 50 or more years ago. We have to look again at our basic premises from a 1980s and 1990s perspective. The New York Stock Exchange has been a leader in self-regulation domestically. It is not clear whether we can fill a similar role internationally.

But the Exchange has not been standing idly, waiting to be overwhelmed by events. To get a better understanding of what is going on and how we look from abroad, we formed a European Advisory Committee to the Exchange Board of Directors. The Committee is made up of chief executive officers of major European corporations. They see us from a different point of view. They tell us about our strengths, our weaknesses, and our competitiveness. They tell us about their needs and how we might meet them. We are learning more about each other.

In addition, we have established an international division at the New York Stock Exchange to see that we are correctly positioned for the late 1980s and early 1990s.

We are also practicing what we preach in the other major area -- reassessing what we have on the books today. We have launched an internal review of all our market regulations. It is a major undertaking that we expect will take about 18 months and could result in a number of modifications we may submit to the SEC.

But this will be only one piece of a larger picture. To complete the picture, all parts of the network -- federal and state agencies, other securities markets, and investment and financial institutions -- will have to do something similar in their areas.

At the Exchange, we are also tapping the expertise of our Legal Advisory Committee as well as our International Capital Markets Advisory Committee and Global Trading Committee. That will assist us in starting on streamlining the regulation and operation of our domestic marketplace.

The other piece of the action is working with foreign markets and government oversight bodies to give some form to what is now being built piecemeal -- an international market for equities.

Some people with the instincts of an explorer have organized services to guide transactions through the international clearance and settlement process. Understandably, they do not all use the same map.

Money managers that invest heavily overseas have also found ways to successfully collect investment information and conduct trading. But before the territory gets carved up into unruly fiefdoms, international clearance and settlement procedures need to be made much more orderly and effective, and consequently, easier to track and report.

The National Securities Clearing Corporation has had considerable experience and success in doing this for our national market system. They have now formed a wholly owned subsidiary, the International Securities Clearing Corporation, to tackle the clearance of international transactions. As a one-third owner of NSCC, the New York Stock Exchange will have representation on the ISCC board. We are also providing major financial support.

The broad objective for international markets is pretty clear. We would like to have an efficient, smoothly functioning, openly competitive international trading system.

We must ask ourselves whether we can justify doing anything less in international securities trading.

Overseas markets are responding to the international stimulus. London is taking dramatic steps this year to make itself more attractive and more competitive. By removing many longstanding "old boy" practices and opening these markets to everyone, they are

trying to create a broad, liquid market for international trading of many financial instruments.

They are dropping fixed commissions in favor of negotiated commissions in October, an event the media have labeled the "Big Bang." And it really might mark the creation of a new financial world there. London, already home for Euromarket and world leader in international banking, could become a strong market for American securities.

And the Tokyo Exchange is broadening its view. Japan dropped the bar to foreign members of the Exchange in 1981. Last year foreign firms acquired six of the ten seats added. Another portent is the fact that the Tokyo Exchange will open a New York office in the spring to attract U.S. domestic listings. The Tokyo Stock Exchange has also embarked on a program of listing the 200-300 world class companies. In 1985, Tokyo increased the number of U.S. companies listed on the Exchange by more than 100% -- from 10 to 22.

With this kind of global competition, compromise and change will be difficult. They are always difficult. But they are a necessary price everyone pays for growth and progress.

Basic principles like investor protection, fair trading, and disclosure of essential information have to be preserved. But we will be successful only if we sincerely welcome change and all parties are open to compromise on their own concepts of investor rights and protection that have been cast in bronze for the last 50 years. We need to recognize that others with historically different social, cultural and political backgrounds do things differently. There will be competition for business within the international system, but there should not be competition to establish protectionist rules that favor one competitor over the other.

And this brings me back to my basic point. There is no stopping the expansion of global trading. If we are going to come up with the best concepts and structure for international trading, all parties will have to work together with a sense of urgency.

We will need experts to guide the transition from where we are to where we want to be. It will take the collective efforts of U.S. and foreign legal, accounting and financial communities.

And there must be leadership that can give power and direction to lift this off the launch pad. The United States is a natural candidate, but not the inevitable choice, for the leadership role.

We have the largest and most diverse financial markets. So we should have the greatest interest in seeing that the job is done well.

We have a long history of melding disparate traditions and systems. And we've earned recognition as leaders in international cooperative efforts in many different fields.

It has been said that there are three kinds of people in this world: those who watch things happen, those who make things happen, and those who never knew what hit them.

For all of us, the period of watching is over. With the bicentennial of the signing of the United States Constitution approaching, we are reminded that it took those 13 separate colonies from 1776 to 1787 to pull together under our present Constitution. Given the magnitude, complexities, and historical differences between countries, this task may prove equally challenging. But if it takes us eleven years to decide on the thrust of our reforms, we will be pushed to the sidelines while more innovative and responsive players from other countries, large and small, take over the game and score the points.

So if the U.S. is still to be the world's preeminent financial market -- and, incidentally, if the New York Stock Exchange is to celebrate its 200th anniversary as the world's leading trading center -- we have to begin building today. Now -- together -- we have to start making things happen, or we will forever be wondering what hit us.

Thank you.

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to exercise my own judgment; and that would be a convenient way to do it.

The other way is for us to have shares of those 300 major, world-class companies available for purchase and sale here in the United States on the U.S. securities exchanges.

I mentioned in my summary remarks that in the past year the Tokyo Stock Exchange has listed 12 American companies, all good companies—top-notch companies like Sears and Security Pacific Bank. A year ago they had 10. They now have 22. Next year they will have 100.

What is tragic about it is the New York Stock Exchange has only eight Japanese companies listed. We haven't listed one in 4 or more years.

RECIPROCAL PROSPECTUS APPROACH

We go over to Japan, we talk to the Japanese firms that are our member firms as well, and they say, we agree with you but we can't convince these Japanese companies to list. They can get everything that you provide by going to Europe or elsewhere without having to meet the regulatory burdens that exist in having a public offering in the Unites States under the SEC requirements.

So if we could have this reciprocal prospectus approach, include the Japanese in it, as some have suggested—and I think the SEC would be receptive, too—that would go a long way toward making those Japanese, European and United Kingdom company shares available to United States investors just as General Motors, Hershey, and other American shares are available today.

Senator **Proxmire**. Of course, if you have a primary domination in this area by a professional, as an institution, it seems to me there is less need perhaps for regulation than if you have ordinary investors in the market.

Mr. **Calvin**. Well, that is true, and you know the securities laws accommodate that——

Senator **Proxmire**. Yes.

Mr. **Calvin** [continuing]. In that a professional can do things, from a regulatory standpoint, that you couldn't do if you were dealing with an individual. But you are absolutely right.

Senator **Proxmire**. But you would expect—pardon me for interrupting. I was just going to say you can certainly expect a much greater investment by the general investing public as time goes on.

Mr. **Calvin**. That is right.

Senator **Proxmire**. And therefore we would need, it seems to me, some additional disclosure regulations.

Mr. **Calvin**. Well, yes. You see, what we have a situation now, in which the barriers are perceived by foreign issuers as so great that they don't come in and make a public offering in the United States. So they don't have to meet the requirements.

On the other hand, American investors can still buy those shares on foreign markets, but with less protection from a standpoint of disclosure and so forth, than they would have if our requirements were more acceptable to foreign companies.

I was the Securities Commissioner in Illinois in my youth, and fellow—you may remember him—Ed Samp, was the Commissioner for many, many years in Wisconsin. Ed did not like investment companies, and he did a terrific job. He got to the point where there were no investment companies selling in the State of Wisconsin; he protected them so well that a Wisconsin resident had to go to Illinois if he wanted to buy shares of Dreyfuss Fund.

And that is the type of situation we are facing internationally today.

Senator **Proxmire**. Mr. Weatherstone, the Investment Company Institute has commented to the Securities and Exchange Commission—this was June 1985—and I quote:

> American investment companies face substantial regulatory difficulties in offering their securities abroad.

And that—

> Foreign investment companies face similar hurdles in offering their securities in the United States.

What steps do you think should be taken to alleviate these difficulties, and do you agree with the suggestion of the Investment Company Institute, and I quote,

> Our Government should start laying the ground work for an agreement between the European Community and the United States permitting international offering of investment companies on a reciprocal basis.

Mr. **Weatherstone**. Senator Proxmire, that particular area is not one in which I have any particular expertise. As a commercial bank, we are limited in the areas that we can cover, so I have to say I can't help you on that question.

Senator **Proxmire**. I appreciate that. You are very modest. I always think of Morgan Guaranty as knowing the answer to everything. [Laughter.]

At least if it is financial.

Mr. **Weatherstone**. I am sure that there are people in the securities activities conducted by the J.P. Morgan Investment Management Co., where we are acting for investors, who could produce a satisfactory answer to that, but that the area that I was addressing particularly, which is the bond markets, the money markets, the exchange markets, is for me a particular area of expertise which doesn't cover the activities you are referring to.

Senator **Proxmire**. Mr. Hormats, do you have a view on that?

GREATER DEGREE OF OPENNESS

Mr. **Hormats**. Essentially, I think more of this sort of reciprocity is probably a reasonably good thing. Over a period of time more and more Americans are going into the European market, and vice versa, and it strikes me that having the greater degree of openness on both sides is useful.

I am far from an expert on this particular issue, but the principle sounds to me to be a reasonable one.

We have spent a good deal of time and effort developing trading relationships in foreign securities or American depository receipts ADR's, listed in the United States, and it seems to me that is a vehicle in the absence of these investment companies having this mutuality here between the United States and Europe.

The other alternative, and I think the alternative we are going to move to over a period of time, is to try to get as many foreign securities listed here as possible.

The advantage here is that while there will be some investors who will invest in a foreign mutual fund, say a German or Japanese mutual fund, who as times go by will want to move up the sophistication ladder, so to speak. That is to say, the first initiative is to go in and buy a mutual fund. But over a period of time, these investors, as they become more knowledgeable about a market, will like to pick particular companies in which they buy stock.

For instance, today if you expect demand in oil to go up over the next 5 years, you wouldn't just want to buy a share of a British mutual fund. You might want to put your money directly in Brit oil, for instance.

If you thought auto stocks were going to go up, you wouldn't want to simply buy a German fund. You might want to put your money in Mercedes.

So over a period of time, as people become more knowledgeable about international markets, they are less likely to try to aggregate and more likely to say, I think the German market is good and I think autos are going to be stronger, and therefore I want to buy Mercedes.

CONSOLIDATED INTERNATIONAL REPORTING SYSTEM

Senator **Proxmire**. Let me ask you this: Do you think that the development of an international consolidated reporting system is a feasible and desirable policy goal, and if so, what problems do you foresee in creating that kind of a system?

Mr. **Hormats**. When you say consolidated reporting system, you mean to have reporting based on similar types of criteria, the same types of reports, Japan, the United States, Europe?

Senator **Proxmire**. Right, yes.

Mr. **Hormats**. Yes; I think that makes a lot of sense. I don't know whether it is possible or not. I suspect that you are always going to find some national differences. But the greater the degree of similarity, the better.

And it is particularly true in one sense, and that is, it goes back to the issue, let's say, of autos. If you are an investor and you expect autos to do well, you will look at, say, five or six major auto companies. You want to be able to look at their reporting and be able to compare Volvo to Mercedes to Ford to Mazda.

Currently, it is difficult to do. So from the point of view of the investor, it is a plus, as well as from the point of view of the issuer because from the point of view of the issuer, it means he doesn't have to change his reporting to go into the American market compared to his reporting in Japan.

So to the degree to which these things can be made similar, it is good from both the investor's side and the issuer's side. Both.

Senator **Proxmire**. Thank you. My time is up, Mr. Chairman.

Mr. Calvin wanted to comment if that is all right.

Mr. CALVIN. Yes, if I could, Mr. Chairman, just two quick comments on the first question that Senator Proxmire raised.

There is an EEC directive that could serve as the basis for reciprocity. I don't have it with me today. If you would like and they are willing, I would be willing to supply a copy of the letter that was written by David Silver of the Investment Company Institute to the Department of Commerce analyzing this proposal and announcing the Investment Company Institute's support for it.

Second, there was a bill sent up by the SEC, I believe, 2 years ago to this committee that would have amended the Investment Company Act of 1940 and provided a basis for the SEC granting reciprocity. It would have made clear their authority to do so. You may want to look at that.

Third, in the tax bill that is now pending in the Senate, the House tax bill, there are some very onerous provisions respecting the taxation of foreign investment companies that really would dampen any type of international securities trading activity. If you could solve the regulatory reciprocity problem, and there are a number of people who have done research on that, it would help U.S. competitiveness.

It is one of these provisions in which they are trying to get at people who have set up investment companies in the Cayman Islands or somewhere; but the provision is so sweeping that it would wipe out the legitimate activities as well as those questionable type of activities. I would be willing to have someone produce a letter stating our position and supply that for the record, if you would like.

The last question was about the consolidated or worldwide ticker tape. That is happening today, Senator, in that the London Stock Exchange, the New York Stock Exchange, and others already use services like Reuters and Dow Jones Quotron that provide an array of market prices from different markets around the world. Other exchanges are thinking specifically about using these services.

The problem is that these markets are different, and therefore you have a real problem in how the information is reported. But there that information is becoming more widely available.

So I think the type of thing you are talking about is going to happen.

Senator PROXMIRE. Thank you.

Mr. CALVIN. I am sorry for the interjection there.

Senator PROXMIRE. Fine.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

SAFETY AND SOUNDNESS ISSUE

Mr. Weatherstone, I might ask you, since you are the international banker here, how does internationalization affect the soundness and stability of the world financial system?

For example, what degree of risk would be posed to international investments from fluctuation in currency exchanges, political instability, a sudden drop in oil prices—for example, if they got into a free-for-all? Does internationalization, in your judgment, make the world financial system sounder or more susceptible to sudden shocks?

Mr. WEATHERSTONE. The internationalization of the financial system enhances trade and capital flows, and the more that we can do to improve that system, the better we shall have equipped ourselves to foster international trade and investment.

If problems develop, for example with particular currencies or commodity prices, that will clearly have some effect on capital flows, but I don't think that we can look to the markets as such and say that they produce extra risks.

I think we understand that there are risks in all these markets, but that all the participants in one way or another are regulated by their own supervisory bodies. With regard to that regulation, it is encouraging that over the last 10 years there have been meetings between the regulators in the different countries, not for the purpose of imposing international regulation over and above country regulation, but in order to coordinate the regulations of individual countries so that we can maintain competition with adequate supervision.

Consequently, I think the regulatory system is such and the cooperation among national regulators is such that we are much better equipped to deal with problems such as violent currency fluctuations and drops in the oil prices today then we were some years ago.

Senator SASSER. Thank you.

Mr. Hormats, one of the key issues—and I might ask Mr. Macklin to comment on this, also—one of the key issues before this committee on a rather regular basis is the concentration of economic power with its associated risk and anticompetitive nature. Of course, the other side of that equation is the advantage that larger financial firms have in competing on a global scale.

Now, the internationalization of capital markets brings, I think, both sides of this question into focus, as we see the trend advancing through markets in New York, in London, in Tokyo.

My question would be: Where does that leave regional firms and regional markets in the United States? Will they have to become captives of larger firms in order to compete?

Mr. HORMATS. Well, it is an interesting question. It is one that I can understand this committee's concern with.

Let me just focus on the regional firms for a moment. First, there is a problem in some regional firms with getting enough capital to do large-scale underwriting.

Rule 415, which is a change—so-called shelf registration—has made it more important that the firms have a substantial amount of capital and placement power in order to buy off the shelf these very large issues and sell them very rapidly. The risk for the underwriter is somewhat greater for those types of issues.

After rule 415 there has been a somewhat greater concentration of power in the bond market among a number of firms, and the statistics are here, which I can provide this committee later on.

ROLE OF REGIONAL FIRMS

But this doesn't necessarily mean that the regional firms don't play a role. In fact, in many areas you have seen a sort of segmented market, with some of the smaller regional investment banks playing quite a large role.

In Baltimore, where I come from, Alex Brown is a firm which has done extremely well. I would say they probably had better returns after rule 415 than before.

Throughout the country there are a number of firms which do venture capital, and some which do localized underwriting for medium-sized firms, which have done and will continue to do quite well.

I have not seen a dramatic weakening of some of those smaller firms.

I still think we have a competitive market and a market in which there are various niches. There are firms that underwrite the Exxon issues or the IBM's, but there are a tremendous number of new service oriented companies that are springing up.

One of the great changes, one of the very healthy changes in this economy over the last decade or so is the enormous increase in firms just coming up in high-tech areas, service areas all across the country, and a lot of that business has been done not by the large New York investment banks but by the medium sized and smaller ones.

Given the diffusion of the economy, given the boom that has taken place, there is probably even a greater role for the smaller firms.

There is also a very good interrelationship between some of the smaller investment banks and some of the larger ones in terms of the way paper is placed and the way clients are served.

Mr. MACKLIN. Much of what has fueled this internationalization has been improvements in technology, communications, and travel. The business that was being done in the way of cross-border investing 20 years ago, although smaller, was very much concentrated in the larger firms that were visible. With the improvements in communications, regional firms are able to identify a niche and be participants.

The firms that want to carve out areas of expertise and merchandise those with institutions throughout the world are now able to do so, whereas previously they weren't. Communications are so good that astute institutions throughout the world, as illustrated by the people in Edinburgh, often will identify areas where they want to invest and then search out and find those regional firms with hands-on expertise that know those areas.

So I think the regional firms that want to participate are strong beneficiaries of the internationalization trend.

Mr. HORMATS. Yes, let me just add one thought. We touched on it a little bit in this hearing. It strikes me that the technology and the communication point that Mr. Macklin has just stressed is probably the key to many, indeed, most of the changes we have been talking about. The ability of someone sitting in Kansas City to know as much about what is happening in the Tokyo market as someone sitting in New York or someone sitting in Tokyo, for that matter, gives him an enormous opportunity to make decisions just as quickly and to have his trade executed just as quickly as someone sitting in one of the large financial centers.

That ability to quickly obtain information and make transactions is quite impressive. It has also meant, and this, I believe, is touched on in Mr. Weatherstone's statement, that people don't need financial intermediaries as much. In other words, they don't always have to go through the banking system. They can make their own risk judgment better because they can have as much information in many cases as the banker. And they can buy and sell directly on the world's capital markets.

Senator **Sasser**. Thank you. Thank you, Mr. Chairman.

The **Chairman**. Senator Dodd.

Senator **Dodd**. Thank you, Mr. Chairman. This has been very interesting testimony this morning.

Let me, if I can, just raise a couple of other questions for you. You have all alluded to, in a very direct way, the problems in the regulatory environment, in terms of the internationalization of this particular issue.

GATT INVOLVEMENT

Tell me, if you will, a little bit about some of the possible trade barrier issues, the General Agreement on Tariffs and Trade [GATT], for instance. There have been recent discussions that we haven't paid enough attention in this country to the service industry area. In fact, there are tremendous problems that exist in that area, and to what extent do international economic conditions play any role in the present problem we are seeing? You talked about the regulatory environment. What impact are those two issues having on the present environment?

Mr. **Hormats**. Let me just make a couple of points. I think, as you know, Senator, because you have played a very active role in this area, in the trade and services area, it is a problem that there is a lot of discussion about and very little real movement on, and that is to say, there has been recognition in the preparatory work for this next round of negotiations—the Canada round or the Brussels round, whatever it is going to be called, that there should be more attention to the financial services.

The establishment of insurance companies abroad has been one of the big issues. American Express has played a key role, because they are interested in having less inhibitions on the use of their card and their other financial services.

There has been almost no talk at all, so far as I am aware, about the ability of banks, investment banks, or investment companies to do business in certain countries. That has really not been a major item on the services agenda. And in part, I think it is because there already is a reasonably good dialog, as Mr. Calvin has pointed out, among the security industries of the various countries.

Senator **Dodd**. I look at your report and I see the number of companies that have Japanese partners, for instance. Is that a problem as well, some of your partners suggested this is not the kind of thing we ought to be raising?

Mr. HORMATS. The people in the industry are making their own relationships. I haven't really heard, at least in the investment banking industry, a great degree of enthusiasm for bringing these issues into trade legislation.

Senator DODD. Why is there not any enthusiasm? Is it a problem or not?

Mr. HORMATS. It is a problem, but I think that the general feeling is that a lot of progress has been made. The Japanese have deregulated a large portion of their industry already. Britain, France, Germany are doing it, and other countries also. They are deregulating, because they've got to to compete with other financial markets. So a lot of progress has been made. It is not as if there has been a stone wall. The progress has been quite dramatic.

France, under a Socialist government, is moving dramatically ahead with less regulation. The British, Germans, and others are moving ahead. And Japan has really led the way in many areas. So progress has been made, and the basic feeling is that there is enough of a dialog among the industries going on. I know what trade negotiations can do and what they can't do, having gone through a number of them. I think at this point, the progress made and the prospects of progress probably mean that there is not a lot of interest in putting them into the trade negotiations at this point.

Senator DODD. Anyone else want to comment on that, but I'd also like to hear about what role international economic conditions—strength of the dollar, for instance—are playing on this particular environment we find ourselves in.

Mr. HORMATS. Just to touch on that last one, there is no question in my mind, but that the strength of the dollar has been one reason there has been so much interest in this country in foreign securities. People felt that when the dollar was very strong, they could buy into these markets cheap, and they could get two plays. One, they could get exchange rate play, when those foreign currencies went up, vis-a-vis the dollar. Second, they expected growth abroad to increase more rapidly than growth in the United States. So they could get a growth play and an exchange rate play.

The other thing is, the ECU market which has been dramatically changed, as a result of the fact that the dollar was very strong. You found a tremendous amount of investor interest going into European Currency Units [ECU's]. You could buy ECU securities. When the dollar went down, the dollar value of the ECU security would go up. So the exchange rate issue has really played an important role in this. And certainly, the volatility of markets has led to the development of a lot of options and hedging in futures market and swap techniques, that almost certainly wouldn't have existed, had there not been this volatility.

Senator DODD. Let me ask, Don, if I can, to you, I think there is an awful lot—a panic mentality can set in. I think you have all made a very good case here today about some things we might do. I get uneasy about rushing into things a little too prematurely, because of what the Smiths are doing down the street. And there are obviously some significant cultural differences, which all of you, I think, in your testimony, pointed to, that create environments that allow for a less onerous regulatory environment or a more onerous one.

How realistic is it—Don, let me address this to you, to the Exchange. How realistic is it, really, for us to anticipate that there's going to be an international set of rules and regulations that we can really function by? How realistic is it to talk about enforcement in those areas? And do we really want to see, in the long run, our own standards be set by what the most attractive market may be, because of the absence of a regulatory environment?

Do you understand what I am driving about?

Mr. CALVIN. Yes, those are all excellent questions really. It is the balance here that one must strike, and I tried to touch on that in my remarks. I think that in his opening statement, Senator D'Amato made the same point.

DOING BUSINESS OFFSHORE

I think what's happening is for real, Senator, and the one area in which there is nearly total agreement on a need to do something is the area of multinational securities offerings. The SEC came out with their concept release more than a year ago. The New York Stock Exchange had made proposals to the SEC 3 or 4 years ago; and it was at about that time that the SEC, for the first time, adopted different requirements for foreign companies who wanted to offer securities in the United States than they did for domestic companies.

So that is not really a new development. But because we have not made the changes rapidly enough to keep pace with what is happening out there, we are finding increasing numbers of U.S. firms that are going offshore. Investment bankers are either advising U.S. companies to do their financing offshore—and that is what the data show—or they are advising foreign companies not to make their offerings in the Unites States. They direct the business to Europe or elsewhere to avoid this problem. Compliance with regulations here is costly, and competition is so great that the American firms are finding it difficult enough to compete with British or Japanese firms, for example, unless they meet them on their own ground, which is pretty much in Europe.

So that is real, and it needs to be dealt with. The SEC agrees with that. They got about 60 or so letters of comment from both domestic and foreign sources. I think there are only two or three that questioned whether this was really necessary. Others thought that there was a need to try to work out some arrangement with other countries so that there would be adequate regulation. That is the other point.

This may sound like a chauvinist statement which will cause snickers from my British friends seated behind me; but if we don't do something to see that there is some sort of a regulatory structure out there, I don't expect that anyone else really will. As you know from your travels, most countries, particularly those in Central and South America, view this capital-raising process differently. They are looking for the money. They are not worried about protection of investors. I mean, they will say to you, we can't afford an SEC now. What we've got to do is get people to invest first.

Senator DODD. That's what I am worried about there.

Mr. CALVIN. Yes. But we've got an SEC, and what we now have to do is to take what we have and look at what is happening and see whether this is really appropriate in light of the context in which we are operating now.

HISTORY OF TOUGH STANDARDS

Senator DODD. That's not what I am suggesting to you. And I am just going to be a devil's advocate to you. But even assuming you could set up a regulatory environment that would be acceptable to everybody, enforcement. We have a long history of very tough enforcement standards in this country, and those of you sitting at that table and in the room here certainly are more familiar with that than I am. And I am not suggesting the United Kingdom or Japan particularly, but other places where that has been far less. Assume you can even establish the regulatory environment. Certainly, the practice of one particular market, because of the absence of enforcement standards that would really make those regulatory provisions meaningful, would, I presume, still add that certain additional attractiveness.

I mean, there is a point at which—what point do you say, I am sorry. We don't go any further than that, or we are not going to buy into that kind of a system, because whatever else you may doing over there, we still believe very firmly in the idea that investment protection is extremely important.

I just wonder what level you go to in this environment.

Mr. CALVIN. You are absolutely right, because you have to reach the balance. Let me back up a moment. It is because of the regulatory environment in the United States that the markets in the United States have developed the way they have. It has been a favorable development. It's also because of the existence of our regulation that a lot of this other activity can occur. In other words, if it were not for U.S. regulation, people would not feel comfortable in doing a Eurobond deal. Even though they don't comply with SEC requirements, you will find they do prepare a prospectus of sorts. They will provide the information, when it comes to the trading markets. We haven't talked about that this morning, but it is extremely interesting, extremely important.

Where you have firms that are literally making markets on a 24-hour basis around the world, they always look to the established markets like the New York Stock Exchange to see whether that price they set at 2 o'clock in the morning, New York time, is really a fair price. They do that for their own self-interest. But they also do it for competitive reasons because they know their customer's going to check at 9:30, when trading opens on the New York Stock Exchange to find out whether he was on that trade you did at 2 in the morning.

What I am saying is that others are also dependent on our regulation. So there is a value to having proper regulation, but if we overdo our regulations, they can become counterproductive. We should not go that far.

Senator DODD. It was going to raise rule 190, was it 190?

Mr. CALVIN. 390.

Senator **Dodd**. 390, a few years ago. The exchange, as I recall, felt very strongly about.

Mr. **Calvin**. We still do, yes.

Senator **Dodd**. I won't raise the rule 390, to find out if there is agreement across the table on it. I would agree with you on that. I know there are a lot of others who had different ideas. Anyway, my time has run out, but I think your last point is one that needs to be made a little bit more often, and that is, the regulatory environment here, while we need to modernize, need to recognize the real world in which we live, it has been a regulatory environment anyways which has been an attractive feature of investing in this particular country. That security, that sense of stability, is in no small measure one of the reasons that we've seen a tremendous amount of capital flight, which I don't necessarily applaud, to other places. It is that stability——

Mr. **Calvin**. Exactly.

Senator **Dodd** [continuing]. That security that investor feels. It may not be quite as attractive an investment in the short term, but that sense of stability makes this country a very attractive market, and I would hate to see us, in the interest of trying to play catchup ball with our neighbors, abandon that particular attractive quality which we have acquired over the years.

Mr. **Calvin**. Yes. We obviously should not do that.

Senator **Dodd**. Thank you very much. Thank you, Mr. Chairman.

The **Chairman**. Gentlemen, thank you very much. Your testimony has been very helpful. There will be some additional questions we would like you to respond to in writing.

[Response to written questions may be found beginning on p. 143.]

The **Chairman**. I'd like to invite the next panel to the witness table. First, we have Mr. Charles Villiers, director of the National Westminister Bank; Mr. Martin Jacomb, executive chairman, Barclays Merchant Bank of London; and Jeffrey Knight, chief executive of the Stock Exchange of London, England.

Mr. Villiers, after 12 years on the Senate Banking Committee, you have set a new standard: the first time we have ever seen bound testimony. You may create great difficulty by setting that kind of a standard on all the witnesses to come before us in the future.

It is very nice. We're not used to such well-crafted beautifully done testimony. So you may have changed the whole procedures of the U.S. Senate Banking Committee.

Would you like to proceed, please?

STATEMENT OF MR. CHARLES N. VILLIERS, DIRECTOR, NATIONAL WESTMINSTER BANK, PLC

Mr. **Villiers**. Thank you, Mr. Chairman.

Well, I'm glad that we are able to set some standards. As I have listened to some of the conversation this morning, I wondered whether we were imputed to have no standards at all in London.

But I think this discussion should indicate that we do have very high disclosure and ethical standards in London.

It's my intention to give a commercial banker's prospective on London's role in developing global markets of the future. And I'll indicate briefly the changes taking place in our business and in our markets. You have already seen my more detailed paper and, in this, I've tried to cover most of the issues addressed in your letter of invitation, particularly the areas of internationalization, securitization, and the resulting issues of capital market risks and conflicts of interest.

London has long provided finance for international trade through its commercial banks and merchant banks, and it's made available international capital through its securities' markets. Over the years, this role has altered with Britain's changing economic position.

LONDON AS THE CENTER

But the last 20 years has seen London as the center in particular of the developing Eurodollar loan and bond markets. These markets grew up in London because it had the necessary infrastructure and traditions, and an acceptable regulatory and tax environment.

The United Kingdom commercial banks played a leading role in the development of the Eurodollar loan market and a United Kingdom merchant bank originated the first Eurobond issue in the early 1960's.

Today, many foreign entities, particularly U.S. investment banks and U.S. commercial banks, have also established significant operations in London, underwriting, trading and distributing Euromarket and other capital market instruments.

The changes occurring in London now have two strands—changes in the structure of the equity in bond markets, that is, all that leads up to the so-called big bank, and changes in the commercial banking market.

These latter changes bring together markets once served separately by commercial and investment bankers. That is, credit and debt securities markets.

Before outlining developments in the London Securities Markets, as they affect commercial banks, I'd like to stress the essential difference in the approach to regulatory separation in the United States and the United Kingdom.

Concentration in the United States is on separation of underwriting and dealing from deposit taking. In the United Kingdom, the need for this has never been recognized. Indeed, it is the banks who have been regarded as the normal and natural underwriters.

The London separation was between brokerage and dealing activities or, in United Kingdom terminology, "broking and jobbing." This was not enforced by statute, but by the 1908 Stock Exchange Rulebook. In contrast, in the United States, you haven't felt the need to recognize this distinction and your investment bankers are both dealers and distributors, principals and agents.

The reason for this very different approach to separation is found in history and are well documented. But, in London, we are now changing dramatically our approach to separation to face the new global marketplace. London was in fact the only major securities market in which there was a separation of brokerage and dealing activities.

And over the last 10 years, economic, political, and technological pressures have been building up against this artificial separation. Indeed, the abolition of exchange controls in 1979 and the rapid internationalization of the capital markets made the pressures unstoppable.

In 1983, therefore, agreement was reached between the Government and the stock exchange whereby fixed minimum commissions would be abolished in October this year. But that agreement had two additional, significant consequences.

First, specific pressure to end the separation of the broker and dealer functions. And, second, substantial additional capital was needed to support the enlarged dealing activities and to meet the increasing inflow of overseas competitors, especially those from the United States and Japan.

The capital of these firms was substantially greater than the existing stock exchange firms and, in some cases, was as large as the major commercial banks.

The greatest underlying pressure has come from the institutionalization and internationalization of savings. Pension funds, money market funds, mutual funds, and insurance companies have been diversifying their portfolios by both geography and by investment instrument.

In addition, many of these institutions were able to bypass the London market and purchase United Kingdom securities through American depository receipts. This proved quicker and cheaper than buying the same shares on the London Exchange.

In some cases, the volume of dealing in these parallel markets was larger than on the floor of the London Exchange. Most significantly, the power and the size of the investing institutions grew disproportionately to the size of the intermediaries.

A further rationale for change was the position of London as the European link between New York and Tokyo. What is emerging is a tripartite type global securities market.

And London had to act quickly to retain and attract business that otherwise would have moved to other centers. It has a number of historical advantages and it needed to exploit them to counteract the advantage of Tokyo and New York and, to a lesser extent, the other European centers.

And one of these advantages is of course the fact that banks and securities businesses are not legally separated as in New York and Tokyo.

I shall now turn to the changes taking place which necessitate banks playing a greater part in the securities markets.

In the last 5 years, the general trend toward lower interest rates provided a greater impetus for corporate and institutional customers to make great use of the long-term securities markets.

Figures show that, in 1980, $29 billion of international bonds were raised as compared with $80 billion of international loans.

USE OF INTERNATIONAL BONDS

By 1984, the figures had reversed—$104 billion of international bonds were issued as compared with $80 billion of international loans, and $44 billion of those loans were debt reschedulings.

At the same time, a wider range of hybrid financing instruments has become available to borrowers. These instruments provide the borrower with long-term finance at short-term interest rates.

Investors in these instruments are offered flexibility through the short-term nature of the notes, plus a market in which trade could take place assuring liquidity.

The channeling of savings into the control of professional fund managers has materially assisted this process. There is now a far less clear distinction between the banking and the securities markets, and I believe this trend to be irreversible. It has forced commercial banks to re-examine their role as providers of financial services to domestic and international charts.

This reappraisal was reinforced by the entry of both U.S. commercial banks and U.S. investment banks into the international debt securities markets in London. They have seized opportunities available in London to undertake businesses close to them in their home markets.

Affiliates of U.S. commercial banks are now significant competitors in the international debt securities markets. Our own adaptation to these changes in London was eased by the absence of barriers to commercial bank ownership of a merchant or investment bank.

National Westminster has been able to own a merchant bank since 1970, and to acquire this year a broker and a market maker.

The development of such integrated financial entities does of course carry implications for capital deployment, supervision and regulation. Two of the most obvious business risks are the trading and underwriting risks.

The trading risk requires capital commensurate with the volume of trading undertaking. There are, however, hedging techniques which offer some cover against adverse market movements.

Underwriting risks depend on the skill with which judgments are made in pricing deals, coupled with a capability to distribute securities to investors. However, banking is already a risk business and, in some significant ways, more risky than a securities business.

I refer, of course, to the greater degree of illiquidity and the longer maturity in their asset profile. Banks have found management and technology controls to deal with risks they incur on the foreign exchange and money markets, and can introduce similar controls to securities risks.

This is not to suggest that bankers can't control or void all risks. Patently, they cannot. And risks also arise as a result of macroeconomic forces and policies for which governments alone can take responsibility.

In this new environment, regulatory authorities will be concerned with the adequacy of capital support for the variety of activities undertaken within one group. There is a need for specific dedicated capital as recognized by the Bank of England in the proposed structure of United Kingdom Government debt market.

Supervision of integrated entities means multiactivity supervision, and identification of conflicts of interest. Conflicts of interest are not new. The principal methods by which conflicts of interest are controlled are either through Chinese Walls or by total physical separation of particular operations.

They're also controlled by an appropriate degree of disclosure and by a high level of competition.

REPUTATION OF THE LONDON MARKET

The most persuasive argument for compliance with rules and regulations will of course be to ensure that the spoils of abuse are outweighed by the penalties of discovery and punishment. The London Market has a high reputation for integrity and a long history of successful self-regulation.

After Big Bang, firms will be authorized and regulated by self-regulatory organizations to whom the government will delegate, some if not all, of its powers. This self-regulation will be undertaken by experienced practitioners.

The overall objective of this regulatory framework will be to ensure that investors have confidence in dealing with firms coming under any particular self-regulatory body.

The internationalization of securities markets raises questions about how domestic regulatory authorities can control the activities of international entities.

There will therefore need to be close liaison between national regulator, bodies to ensure common standards are applied. The liaison ought, in our view, to seek reciprocity of treatment for all participants in particular national markets. This will ensure that the benefits of internationalization of the securities markets and competition are freely and fully available to all those who use these markets, either as borrowers, investors, market principals, or depositors.

In summary, the business environment in which we operate is in a rapid process of evolution, due to improvement in technology, securitization, and internationalization. This process is inevitable whether or not individual domestic markets or commercial banks, for that matter, participate.

The underlying needs of issuers and investors, borrowers and depositors remain constant. It's the business practices and methods of meeting these needs more efficiently which change, and which are in fact changing on a worldwide basis.

Innovations in changes in the markets are most frequently adopted, first by the larger and most creditworthy customers. It is therefore the quality portion of the commercial bank portfolio which is affected first. The regulatory changes in London will now allow us as a commercial bank to adjust and to maintain the relationships with such quality customers and, thus, the overall quality of our portfolio.

I thank the committee for the opportunity of participating in this panel, and I will be pleased to answer any questions on what I have said and what I have written in due course.

The CHAIRMAN. Thank you very much.

Mr. VILLIERS. Thank you.

[The complete prepared statement follows:]

Testimony of National Westminster Group
To
United States Senate Committee
on Banking, Housing and Urban Affairs

Charles N Villiers
Director, National Westminster Bank PLC
Chief Executive Elect, NatWest
Investment Bank

26 February 1986

Statement of Charles N Villiers

National Westminster Bank Group

Mr Chairman, Members of the Committee, my name is Charles Villiers. I am a Director and General Manager of National Westminster Bank PLC and Chief Executive Elect of NatWest Investment Bank. I seek to cover in this written submission certain of the issues raised in your letters of 6th and 14th February 1986, and have addressed those most appropriate from the point of view of a major commercial bank participating in the international securities markets.

Background to Market Changes and Internationalisation

The liberalisation of the international wholesale banking and securities markets is by now inevitable for a variety of reasons and is virtually irreversible. The main beneficiaries of this process have been customers, who have received the benefits in terms of new services and fine margins from the innovation and competition among financial institutions. Some of the main reasons for this development are:-

1 The infrastructure for a worldwide financial system is now in place, including global networks of banks and securities houses, and transaction systems for payments (SWIFT, etc) and for bonds (CEDEL and Euroclear, etc.);

2 The financial system is experiencing a wave of innovation in terms both of marketing structures and of the development of new products (securitisation of lending, revolving underwriting facilities, etc.);

3 Major banks and securities houses have global strategies and intend to operate in the three time zones of Asia, Europe, and North America. Bargaining is taking place between countries to enable the main representative organisations of those countries to have access to business in the three zones;

4 Customers are now faced with a much wider choice as to the method of effecting any particular transaction. For example, a company could borrow sterling in London or it could borrow dollars in New York and swap them into sterling: an investor could trade British stock either in the London Stock Exchange or in New York through American Depository Receipts;

5 Technology is developing at an exceptionally rapid pace with two main effects. The first is on calculations. Financial calculations of exceptional sophistication may be carried out quickly and in large numbers, thus making possible for example the modern foreign exchange market and the modern futures markets.

Technology is also bringing down enormously the cost of communication and making it more efficient. Global dealing only becomes possible on a large scale when there are global information systems, which now exist. Estimates have been made that between 1964 and 1985 the cost of transmitting information fell by 95 per cent, and that of processing information by 98 per cent;

6 Financial market customers are now very sophisticated, through education by their own efforts, by the media and by the markets, and are now themselves exerting great pressure on the markets. If any part of the market is not competitive then it will not do business. Protected corners of the market are being squeezed out;

7 Financial organisations have spare capacity and can afford to invest in available markets, thus intensifying the competitive pressure on all concerned. As an example, with the liberalisation of the London gilt-edged market, nearly $1 billion was committed to that market in a matter of weeks and with no great difficulty;

8 Countries are in many cases liberalising their marketplace, and thus opening them to international competition. This may take place because the government believes in liberal markets (the United Kingdom), because the government wishes to stimulate hitherto protected parts of the financial system (Australia), or because the government wishes to ensure that financial market activity stays within its own borders and does not move abroad (West Germany). Whatever the motivation, these acts of liberalisation and deregulation tend to be irreversible, and have the effect of making the world one large financial market.

The same economic forces are now being seen in the United States with institutions positioning themselves to take advantage of the new range of costs and opportunities. Modern technology means that many functions are being carried out nationwide, which would have been impossible in past technological configurations.

The United Kingdom banks have no objection to the liberalisation of the London markets, but wish for effective reciprocity and full opportunities in the banking and securities markets in the major financial centres-worldwide, which include New York and Tokyo as well as London.

The Development of International Markets

The international markets is a term which covers two different distinct groups. One is foreign markets, which is best regarded as other countries' domestic markets. Thus, Germany, Switzerland and the United Kingdom have domestic securities markets, under their own national jurisdiction, but which are international as far as a United States organisation is concerned.

Euromarket Development

The second type is what might be termed the more fully international markets, the euromarkets. All action in these markets obviously takes place under some law, but the essential feature is that it is not tightly restricted by national governments and central banks so market-making may take place with considerable flexibility. In view of the freedom in the euromarkets, they have been a source of major innovation and a pace setter for developments in other, national, markets. The euromarkets, as distinct from the foreign markets, may have tax or administrative advantages. For example, interest on eurodollars is paid gross without being subject to any withholding tax.

The international markets have grown considerably in recent years. The first major international market was the eurocurrency market, which developed during the 1950s, and had by September 1985 reached a total of $2347 billion. Side-by-side with this there grew up a eurobond market, under which bonds could be issued in a variety of currencies, in many cases with the bonds being registered in one of the European stock markets, such as Luxembourg or Brussels. A key feature in the development of the euromarkets was the creation of the financial infrastructure, and notably in the case of bonds the establishment of two clearing houses, named CEDEL and Euroclear. Euroclear was originally founded by Morgan Guaranty, and is still managed under a management contract by them. CEDEL was founded by a group of European banks in rivalry with Euroclear. Euroclear is in Brussels and CEDEL in Luxembourg. These organisations provide a fully comprehensive and efficient bond clearing service.

Capital market activity has expanded sharply in recent years for several reasons. The general diminution in inflation worldwide led to increasing confidence in long-term markets and hence to a willingness of investors to invest in bonds at interest rates which were considered reasonable by borrowers.

Institutional Savings

The worldwide institutionalisation of savings through pension funds and life insurance companies has created large scale pools of savings and has placed them in the hands of professional managers.

These professional managers sought to diversify their portfolios and have welcomed the opportunity provided by the growth of capital market issues to obtain a spread of risk at acceptable rates of return. Numerous surveys, including those undertaken by my own organisation, evidence the increasing percentage of international investments held and sought by fund managers; and the increasing acceptability of various international investment instruments from debt to equity.

A major economic change has been the accumulation by certain countries of large current account surpluses and the corresponding need to generate capital outflows. Their surpluses need efficient large scale investment outlets.

The need to service institutions on an international basis and in a variety of investment instruments is therefore paramount to a financial services institution seeking participation on a global basis, both in debt markets where there is clear evidence of the demand for foreign government and other fixed rate instruments and also equity stocks. The market is in our opinion moving towards distribution on a global basis for all instruments. If the global participant's ambition is to originate and distribute internationally, it must look for a global capability in the primary markets, and by definition a significant and supportive role in the secondary markets.

Development of the Hybrid Instrument

Many international investment banks have taken the opportunity of pressing innovation on the market. In doing so they have blurred the historic distinction between long and short-term investments from the point of view of investors and, at the same time, have enhanced the attractiveness of bonds in contrast to bank lending as sources of finance for the most creditworthy institutions worldwide. The creation of note issuance facilities, revolving underwriting facilities and other innovations has widened the appeal of the capital market both to borrowers and to investors (see Table 1).

Thus a note issuance facility, to use the generic term, combines the advantages of the short and long term markets. The borrower is guaranteed the availability of funds for the total maturity of the facility, say, eight years. However, since the money is borrowed only for, say, three months at a time, he pays short term interest rates which would on average be lower than medium-term rates. On the other side, the investor holds liquid short-term paper (say three months), rather than less liquid, medium-term paper. These innovations thus create genuine benefits for investors and borrowers.

As a result, the use of capital markets has expanded very rapidly in recent years, and money raised in them has outweighed that raised from the international banking markets (see Table 2). United States institutions have played a major role in these markets, and as indicated above they have played a significant role in the clearing system for bonds. They have been very active in arranging bonds, as indicated by Tables 3, 4 and 5, giving the rank order in recent years for bond issues.

The United States Domestic Market

The main effect of the current liberalisation in the marketplace, driven by competitive pressures and technology, is to give market participants a wider choice of financial instruments to enable them to transact their business over a wider geographical area, and to offer them better prices. The United States is a continent, and many parts are thus likely to be more insulated from conditions in the international marketplace. Nevertheless, these same forces of technological progress, innovation, wider consumer choice and international competition are likely to be felt both in the banking and the securities markets. In the banking markets much business which was done at wider margins in bank loans may now be done on finer margins in the securities markets. In general, the wholesale corporate and other institutional business becomes much more competitive. This would thus reduce banking profits in that field, but would have less of an effect in the middle market and in the retail market.

In the securities markets there is greater opportunity in the form of more primary business but competition is stronger and more widespread. New sources of income are developed, such as through the turnover generated by new instruments. New techniques such as loan slicing and swaps provide institutions with new sources of profits. Under the present competitive system there are rewards for innovation, energy, and low costs, and penalties for excessive costs or an over-attachment to traditional ways of doing business.

Attempts to split the financial sector, into a securities sector and a banking sector, have little relevance on the pricing structure in those industries. Their main effect is to penalise institutions which find themselves caught on the wrong side of a particular definition. The competitive forces are worldwide and cannot be checked simply by splitting off some sector of the domestic economy.

Developments in London

(i) Equity Markets and 'Big Bang'

The most striking liberalisation of financial markets in Europe is in London, where the institutional structure of the Stock Exchange has been changed radically.

The catalyst for Stock Exchange deregulation was the case which the Office of Fair Trading (OFT) brought against the Stock Exchange in the Restrictive Practices Court in 1979. The Director-General of the OFT sought to challenge the Stock Exchange 'Agreement' on the basis of a number of restrictive practices. The case centred on three areas in particular: the fixing by the Stock Exchange of minimum commissions; single capacity (the separation of the functions of jobber and broker); and outside representation, notably the difficulty experienced by outsiders in gaining access to the Exchange. Irrespective of this case it was clear that there was a need to update and reform some of the Stock Exchange's practices in response to the changing financial environment. Both the Government and the Bank of England were anxious to see the emergence of larger, more heavily capitalised and broadly based UK firms capable of competing on a worldwide basis in international markets. US and Japanese securities houses especially are much larger than UK counterparts. It has been estimated that, before outside organisations began to acquire stakes in Stock Exchange member firms, the combined total capital of the latter was less than that of the largest US brokerage group, Merrill Lynch & Co Inc.

To avoid what would almost certainly have been protracted litigation the Government in July 1983 invited the Stock Exchange to consider a settlement. In return for certain concessions, the Government offered to exempt the Stock Exchange Rule Book from the Restrictive Practices Act and thereby remove the basis of the OFT case.

The principal result of the accord between the Stock Exchange and the Government has been the recapitalisation of the leading member firms to better equip them for the future. This has been achieved by outside organisations, especially banks, acquiring stakes. The maximum permitted stake which an outsider can take is at present 29.9 per cent, although since June 1985 there has been no limit on the number of such investments. Previously, second and subsequent stakes were limited to 5 per cent. The Stock Exchange will allow outsiders to aquire full control of member firms after April 1986. Dual capacity trading (the combination of the broker-dealer function) will follow in October 1986 when minimum commission scales on domestic securities will no longer apply.

As a result of these developments, the vast majority of Stock Exchange firms have been taken over by outside companies or have merged. These new owners include financial institutions from all round the world, making the London Stock Exchange perhaps the most internationally owned of any major stock exchange. See table 6.

(ii) The UK Government Debt Market

At the same time, the British Government decided to change the system of dealing in government stock. Hitherto, government stock had been sold to the Stock Exchange through the government broker, and through two jobbers ('market-makers' or 'principals'). The new structure of the Stock Exchange made that a somewhat outdated method, and so a system not unlike that in the United States was created, whereby the Government will deal with 'market-makers' in government (gilt-edged) securities. Conditions have been stipulated as to the separate capitalisation and integrity of these institutions. Following the receipt of applications, the Bank of England announced that 31 companies had been accepted as market-makers. Two withdrew their application, leaving 29 market-makers in place when the new system begins. Virtually half of these are non-UK owned, as indicated by Table 7.

The Government has been concerned that the new structure would be less efficient in guaranteeing the effective sale of government stock and the necessary liquidity in all market conditions. As a consequence safeguards were built into the market-making system, including the obligation to quote two way prices and to deal at all times. The new market structure is likely to be at least as effective and liquid as its predecessor. The much greater capital in the market and the increased competition are likely to lead to keen prices and low commissions, to the benefit of both borrower and investor.

As a result of this enormous change in the London markets, London has clearly become the main capital market centre in Western Europe, and many companies have built up or moved their international capital markets activity into London. The growth of the banking euromarkets and the eurobond market in London's liberal regulatory enviroment contributed to making London a major world financial and capital markets centre.

The Trend Towards 24-hour Trading

There has always been some 24-hour trading in financial circles, such as banks in the foreign exchange markets. This involved either maintaining a position in the same organisation or, say, London trading with the Far or Middle East as it is closing and with New York as London closes.

Something much more significant is now emerging; trading in the same instruments, around the clock, with an ability to offset with no additional risk, under a widely accepted but largely unwritten set of rules. This market is being driven by both:

(a) **demand** by major corporates for a wider market for their issues, better price support, less chance of a 'raid' if paper is more widely held and good international public relations.

(b) **supply** — being the growth of international trading houses which are willing to trade and make markets worldwide, the trend towards securitisation which has to be efficient to be effective, the increasing ease of all forms of communication and the profit motive.

On the buyer side there is the increasing importance of the large institutional investor, who wishes to spread his risk across countries and currencies as well as industries.

There is ample evidence of these trends:

International Issues	— Simultaneously — such as British Telecom and Reuters — Specifically international — like Britoil — Global — quasi equity — Nestlé — Domestic issues with foreign underwriting — Worldwide stock exchange company listing
Exchange Hours	— Recently extended in Amsterdam, Wall Street, Tokyo, etc. to facilitate continuous world trading.
American Depository Receipt and similar	— The huge growth in the American Depository Receipt market and related developments in EDRs, Euroclear, etc. (More than 50 per cent of ICI, a major UK company, is now traded in American Depository Receipt form.)
Internationally owned shares	— As a result of market liberalisations, holdings of foreign investments by institutional investors have grown significantly in the last few years. In the UK alone, estimates suggest foreign holdings have increased from 10 per cent to at least 25 per cent since the abolition of exchange control in 1979.
Stock Exchange turnovers	— Many exchanges have recorded huge increases in their indices and turnover as a result of foreign investment, eg West Germany, Austria, Italy.
Research	— Now being offered on an international as well as on a national, sectoral basis.

There are estimated to be up to 500 stocks traded regularly worldwide — split as follows:-

US 250, Japanese 110, UK 40, West German 20, Canadian 20, Swiss 10, Italian/French/Dutch/Australian/Hong Kong 40, Other 10.

Trading 'on' and 'off' Exchanges

There has been trading off the exchange in recognised international stocks for many years. It was formerly only a very professional market with specialities like South African gold shares — used extensively for arbitrage. These transactions were, however, brought back to the home exchange where the underlying deal was completed. With the demands of the large institutional investor for block trading, the emergence of sophisticated information technology and more paper to trade, the pattern has changed. The freedom and success of the bond markets has been encouraging for off-floor trading. This trend affects national as well as international exchanges, and there is a suggestion that market floors could become mere price indication mechanisms.

A great deal of this business is external to the underlying home market, and hence beyond the scope of presently available statistical measurements, making estimates of turnover volumes very problematical.

Linked Exchanges/Global Markets

Very little success has been achieved in linking exchanges.

It is true that the technology in one form or another exists, but against that the major requirement is for worldwide compatibility in such areas as:

(i) Clearing facilities, where there is a need for either a universal system including common settlement times or at least proper linkages between exchanges and full fungibility.

(ii) A common environment, which needs to include accounting standards, legal requirements, regulatory, enforcement and disclosure issues, surveillance and taxation levels to reduce tax-led arbitrage.

These requirements involve major competitive and sovereign issues; consequently they will only develop if there is a sufficient focus and commitment over an extended period.

Regulation of Securities Underwriting

British merchant banks, which are rough analogs of US investment banks, but can be owned by commercial banking groups and take deposits, have always been involved in underwriting securities; over the past 10 years this has been a significant activity in the eurobond markets, where the majority of the leading participants are part of commercial bank groups, and in the domestic markets they have been the principal underwriters in the equity markets.

In the London market there are no regulatory problems; the considerations being principally those of risk and conflict of interest. These have rarely caused any problems in the past 20 years.

In the majority of cases, the entities involved in securities underwriting of whatever sort are separately capitalised and the risks are separately appraised.

Conflict of interest issues are addressed separately in this paper; the risks inherent in underwriting an unsuccessful issue are costly in both money and reputation terms, and the originator or distributor who gets it wrong in terms of price or who does not play according to the externally and internally applied rules will find no further favour in the market from borrower or investor.

Liberalisation Internationally

As a result of the London changes, other European countries have been stimulated to liberalise their markets. They could see capital market activity moving from their own jurisdiction abroad, if their own jurisdictions could not offer the same competitive services which financial market customers could obtain elsewhere. Thus, both Germany and Switzerland announced in May 1985 that they would permit the subsidiaries of foreign institutions to co-lead manage deutschemark and swiss franc foreign bonds respectively.

In May 1985 Germany abolished the cartelised control over bond issues, and announced that lead managements of deutschemark eurobond issues could be assumed by foreign banks incorporated in the Federal Republic. At the same time it was announced that certain new financial market instruments, notably zero coupon bonds and swaps, would be permitted. The main barriers to liberalisation in Germany remain the high minimum reserve requirements on bank deposits and the transaction tax on stock exchange turnover. Moreover, the stock exchange is fragmented into eight regional exchanges, which makes it difficult to provide modern dealing systems at the same cost as in unified exchanges. Some progress has been made, in discussions between the regional stock exchanges, and they may try to move towards a unified system. Nevertheless, progress is likely to be relatively slow and it will be many years before Germany can offer a stock exchange system comparable with that of New York or London. Germany is now liberalising further through allowing banks to issue certificates of deposit, which has hitherto not been allowed.

The Swiss also announced in May 1985 that they would permit the subsidiaries of foreign institutions to co-lead manage swiss franc foreign bonds. This market has in the past been dominated by the three major Swiss banks, but over the years competitive forces stemming from the activities of the smaller banks and foreign institutions had eroded their pre-eminent position. Both Germany and Switzerland announced that these concessions relating to the lead management of bond issues would not be permitted for Japanese institutions, given the lack of reciprocity in dealing with that country.

The Netherlands joined with Germany in announcing that they would allow a wider variety of financial instruments in their marketplaces, including floating rate notes, swaps, and zero coupon bonds. The Amsterdam Stock Exchange, which is relatively small, but has a flexible and internationally minded tradition is now embarking upon a process of liberalisation and modernisation to enable it to remain competitive with stock exchanges elsewhere.

France, too, has embarked upon a policy of financial deregulation as a means of stimulating and making more efficient its financial system.

Events in Japan have been influenced heavily by Article 65 of the Securities and Exchange Law of 1948 which in effect mirrors the Glass-Steagall restrictions. Moreover, Japan has generally been reluctant to allow foreign owned firms to have access to the securities market. Nevertheless, in recent years Japan has liberalised in response to foreign pressure and changing market conditions. Six foreign firms have been allowed membership of the stock exchange.

In addition foreign banks have formed trust banks, usually in conjunction with a Japanese partner. These banks are Citicorp, Chase Manhattan, Morgan Guaranty, Chemical Bank, Manufacturers Hanover, Barclays, Union Bank of Switzerland and Credit Suisse. Fourteen foreign banks have securities branches in Tokyo, some through part-owned subsidiaries. These are Citicorp, Security Pacific, Warburgs, Schroders, Kleinwort Benson, Cazenove, Jardine Fleming, Merrill Lynch, Morgan Stanley, Salomon Bros, E F Hutton, Paine Webber, Goldman Sachs and Deutsche Bank. National Westminster hopes to join this list.

Further liberalisation is expected, with other companies being expected to be allowed to form securities branches, through subsidiaries in which they hold a 50 per cent interest or less. Nevertheless, even after these moves, the right of access to Tokyo will be significantly limited in relation to that available in other countries, notably in London.

Apart from concessions on market access, Japan has also been showing liberalisation of market structure for a variety of reasons. Without setting out these changes in any detail, the factors which have led to this change are significant. These include pressure from abroad, particularly from the United States. Competitive factors have come into play: since Japanese institutions could increasingly use the international markets where rates on yen instruments were determined by market forces, this exerted pressure for rates on domestic instruments to be treated similarly to be competitive with international rates. The corporate sector was becoming less reliant upon short-term bank finance, and in greater need of access to equity finance and for outlets for its liquid surplus. The massive Japanese fiscal deficit required equally substantial sums to be raised, and increasingly this could not be done unless the government was willing to pay competitive interest rates.

The result of these pressures is that, broadly speaking, there is more market determination of wholesale interest rates in Japan, while there is still administrative control over interest rates at the retail level. This process has been linked with institutional creativity, with new markets being established such as markets for yen denominated bankers acceptances and bond futures. Preparations are being made for the establishment of a short-term government bond market. Previously, Japan has been regarded as wishing to regulate financial flows and to use various rationing techniques to allocate credit to the priority sectors, which traditionally have been the industrial and commercial sectors. But the changing balance of the Japanese economy, which is now accumulating substantial trade surpluses and becoming a major financial power, together with the changing financial situation at home and abroad, have pushed Japan very sharply towards wishing to free its financial markets and towards taking effective steps to that end.

Reciprocity

Comprehensive information on the role of reciprocity in the internationalisation of the markets is not fully available, because many of the international negotiations on liberalisation are kept confidential. Most countries operate policies on the basis of a mixture of national treatment and reciprocity. It is not always possible to discern the balance between reciprocal considerations and the application of normal national policies.

In the United Kingdom and the United States access by foreign institutions has been generally on the basis of national treatment. This is indicated by the presence in London of banks from many countries where similar access is not allowed to British institutions. Nevertheless, the authorities have recently indicated vigorously that they would expect British institutions to have a right of fair access to the Japanese market. Applications by Japanese securities institutions for banking licences in London have been declined on the grounds that they are not constituted and supervised as banks in Japan.

When in May 1985 the Germans and Swiss announced that foreign owned institutions could co-lead manage deutschemark and swiss franc foreign bond issues, this change excluded Japanese owned institutions on grounds of reciprocity. German and Swiss institutions did not have adequate access to the Japanese markets. It would not be appropriate for us to comment on other countries. The general conclusion is that the bargaining power of the major countries is such as to ensure general reciprocity, at least for the most significant institutions in their countries. In the United Kingdom there are no rules equivalent to Article 65 of the Japanese Law or the Glass-Steagall Act, so that United States commercial bank affiliates and Japanese banks and securities houses may operate in both the credit and securities markets. This full market access is not allowed at present to British institutions in either Japan or the United States.

United States Competitiveness

In general, United States financial institutions, including commercial banks, have not been restricted from operating in the international markets because of restrictions in the United States itself. While there may be particular permissions required for certain activity, nevertheless the impression from abroad is that the United States institutions have full and free access to the foreign marketplace. This is indicated by their market position in various league tables of business done. There may be some markets in which United States institutions are not allowed to participate because of reciprocity considerations, but this does not currently apply in London.

The Benefits of Internationalisation

The process of internationalisation implies the opening of markets previously closed or in some form protected from the forces of additional competition. Allowing in new market participants produces a corresponding increase in the volume of capital dedicated to the market in question, together with a corresponding increase in market liquidity. In the eurobond market, where there are no formal barriers to entry, the increased liquidity is evidenced by the growth in turnover through the clearing houses CEDEL and Euroclear. Between 1974 and 1984 their respective turnovers increased from $8 billion to $519 billion, and $8 billion to $1030 billion.

These figures point to the existence of greater capital employed in the market, together with increased trading which facilitates market liquidity. The same process can be seen in other markets that are opened to new entrants. When the Bank of England proposed changes in the structure of the UK government debt market, which previously was dominated by two large entities, twenty-nine agreed new entrants, including some of the largest US investment banks, committed in total nearly $1 billion as previously indicated.

The benefits of these processes are clearly seen in the development of new financial products, such as swaps, which is now a $180 billion market, and the euronote market, which despite being less than three years old, has grown to be a $30 billion market showing continued growth.

These types of product innovations, which have emerged in open markets, have produced direct cost benefits to corporate and institutional borrowers. They enable creditworthy borrowers to access foreign markets from which they were previously debarred, and at the same time, reduce the cost of capital to the borrower.

Thus, internationalisation implies not merely larger and more liquid markets, but also more homogenous markets, insofar as market practices and innovations that find favour with corporate and institutional borrowers are rapidly transferred across national boundaries and become generalised, to the benefit of borrowers.

The Soundness and Stability of the World Financial System

The world financial system may be considered at two levels, the first being relationships between governments and between national monetary systems. The world is now in a floating exchange rate system, with currencies in the main blocs free to move against each other.

The main effect of the internationalisation of finance is that the monetary systems of the main countries are now much more closely integrated to each other. Foreign exchange markets are influenced much more by capital flows and by monetary movements than by underlying commercial transactions. For example, the daily turnover in the world's foreign exchange markets is estimated at some $150 billion which is some 12 times world trade. (In 1984 world trade was $3 trillion or some $12 billion a day.)

This means that it is much more difficult for countries to pursue fully independent monetary and financial policies. It also means that if the commercial markets think that an exchange rate should move, for example, then a mixture of speculative and hedging activity could bring substantial financial pressure to bear on that exchange rate relatively quickly. It is thus much more difficult now to have a system of fixed exchange rates than it was in the immediate post-war period, when capital flows were much smaller and markets were used to stable and fixed exchange rates.

The effect of the volatility of exchange rates is that they are increasing risks for market participants, including commercial and financial organisations. It was as a result of this that many of the markets have developed, such as futures markets, which give participants an opportunity to hedge their risks. It is also because of this that investors seek a wider spread of risks across national boundaries.

The second level relates to the soundness and stability of the major worldwide financial institutions. The question is whether there is greater likelihood of a major institution collapsing, and if so whether there is a greater likelihood of that having a chain reaction effect on major institutions around the world.

There is undoubtedly a great integration of financial institutions, which means that problems may develop rapidly. There was approximately a fortnight's time between first serious attempts to withdraw funds from Continental Illinois and that bank's collapse under liquidity pressures. However, there was no chain reaction stemming from Continental Illinois' difficulties, and the problems were contained within that bank.

Undoubtedly, the internationalisation of the marketplace means that institutions are taking part in new business areas and are therefore taking on different risks. While it could be argued that a greater diversity of business makes a financial institution sounder, nevertheless these particular new risks need to be guarded against.

To a very large extent the institutions themselves, which comprise the largest banking and securities houses in the world, have adapted their management techniques so as to deal with this situation. There have been many fewer problems in the international capital markets, particularly the Eurobond market, than there have been in many domestic markets. The most effective way to guard against new problems arising in the international markets is for the institutions operating in those markets to have effective management systems, and for the supervisors responsible for those organisations to do their job thoroughly. Almost all the major losses in the world's banking system since the war have resulted not from any failure of international supervision as such, but because either the banks had lax management controls and were perhaps defrauded by their own employees, or because their own parent central bank was not supervising the markets effectively. In banking the current practice is for the parent central bank of a bank to have the dominant duty of supervising that bank worldwide. Providing that responsibility is carried out effectively, and providing the banks and securities houses continue with their careful and cautious policy in the international markets, then there seems no reason why the risks in the international marketplace should threaten the soundness and stability of the world financial system, or should indeed be any greater than in other markets.

Risk

It is natural that when new developments take place in financial structures, with commercial banks taking an interest in the securities business, then concern should be expressed whether the risks are being assessed properly and guarded against. While it is natural to express such concerns, on looking at the evidence one sees little indication that such concern is fully justified. The classic example of banks which have historically taken very active parts in both commercial banking and securities business is that of banks in Germany and Switzerland. Universal banking has been for many decades the norm in such countries. No one has to our knowledge ever implied that those banks are in any way riskier or less sound than banks elsewhere, and in fact we believe the major German and Swiss Banks to have conservative and prudent reputations.

Some security market activities have no particular risks at all, such as fund management.

Broking as such is not risky, although revenues may vary significantly during the cycle in accordance with market conditions and it is necessary to adjust costs accordingly.

The most risky areas of security market activities relate to trading, of acting as a principal or market-maker as well as a broker, and to underwriting. In the former case the risks are essentially of being short when interest rates fall or stock prices rise, or being long in a bear market or when interest rates are rising. The appropriate remedy is to control the positions being taken on a continuing basis, and to ensure that the maximum risk in relation to the capital of the institution is always kept under control. It is desirable that the positions and risks taken by the organisation should be closely related to the capital employed. In National Westminster's case we have capitalised the NatWest Investment Bank at £300 million, and have capitalised the gilt-edged market-making capacity in the British bond market at £25 million. This compares with total National Westminster Group capital funds of £4387 million.

The risk from underwriting is that prices may fall between setting the price and distribution, leaving the underwriter with a running loss. Again the only protection against this, apart from good business skill in selecting underwriting positions to take, is that any risks adopted should be limited in relation to the capital of the organisation.

One should not look at the question of risk solely from the negative point of view. Financial institutions are normally regarded as stronger if they have a wide diversity of exposures, and if those exposures are affected by different factors. Bankers speak in terms of having a well spread portfolio. The benefit from this structure is that the banks take continuing profits from this widespread portfolio, while any losses become relatively smaller, in view of the greater average profit, and are also most unlikely to coincide as between the different types of risk. Thus diversifying the portfolio of business, including taking on securities business, should strengthen a financial institution.

Financial institutions such as banks are already experienced in controlling dealing risks, such as in their foreign exchange trading rooms, where in fact National Westminster Bank is particularly active. Commercial banks have also taken part in sophisticated markets such as futures, swaps, and forward markets. The banks are already experienced in setting up the control systems for trading rooms. In this regard, modern technology may well in fact have made it easier for control to be exercised. While helping create the modern markets, technology also creates the ability to control the positions and risks which are undertaken.

Technology has also helped create new markets which make risk control easier. The futures and options markets, for example, enable exposure to be hedged, and thus reduce the risk of engaging in the securities business.

Perception of Banks

In general the reputation of banks worldwide depends on their standing and efficiency, rather than on the balance of their activity. Thus, for example, the German and Swiss banks have generally high reputations, and they deal in both the banking and securities markets. In as far as they deal efficiently in the securities markets, then banks' reputations will be enhanced. Many banks, including National Westminster, have in past years enormously enhanced their standing by becoming major international banks. In as far as an active position in the securities markets is necessary for banks to cover the marketplace efficiently, then doing so should enhance their reputation also.

A profile of a bank to its customers must depend very much on the particular customers. The profile to a corporate treasurer will be different from that to a retail depositor. In general, the impression given to retail depositors is likely to be linked heavily to their most immediate contacts, such as in branches and along the high street. One would expect the general success of a bank, as indicated by its effective use of worldwide markets, to improve its profile to depositors. .

Conflicts of Interest

One of the criticisms made of commercial banks engaging in the securities business is that they may face severe conflicts of interest in their relationships with their customers. It is certainly true that the wider the range of the financial markets in which a bank operates, the greater the number of products it has to offer customers and, therefore, the greater the likelihood that the bank's legal position and interests in relation to some products might possibly conflict in relation to others. Whilst one can accept this argument in principle, it is difficult to know how important it really is in practice. The principle as such is, of course, recognised in the supervision of financial markets and of financial institutions, and steps are taken to deal with it.

The banks operate with 'Chinese walls' which separate people operating in different functions, and who are not permitted to discuss business with each other. In many cases business takes place in completely separate locations. Most companies, including ourselves, are creating compliance departments to ensure that the supervisory rules are being adhered to completely. Many countries have rules covering conflicts of interest, such as for example those against insider trading. In the United States the Securities and Exchange Commission and in the United Kingdom the Take-Over Panel regulate the merger and acquisition business, setting rules for the participants. Currently a new Financial Services Bill is being debated in our Parliament which specifically addresses these problems.

There are inevitably certain potential abuses of position which could take place in a securities house itself. For example, most securities houses would be engaged in funds management, trading on stock exchanges, and underwriting new issues. There may be the temptation to use the funds under management to support new issues, by putting the less attractive issues into the funds, or to supplement the income of the house by turning over the funds under management unnecessarily, churning them, so as to enhance the commission income. The fact that these abuses have always been possible in most merchant banks and securities businesses has not prevented such companies operating effectively, under good supervision, and with customers having confidence that their interests are being carefully safeguarded. Linking a commercial bank with securities trading would increase only to a modest extent the conflict which might arise in any financial market situation. We believe there is little change in the quality of risk; only in the quantity, and existing methods of control can be applied satisfactorily to the new situation.

People who express most concern about conflicts of interest may be under an illusion as to the market power of financial institutions. If a bank is a dominant lender, and is also a dominant participant in the securities market, then a company might feel that it was to some extent 'at the mercy' of that particular bank in both its banking and its securities business. But such situations are far from the truth. In most securities markets and in most banking markets and certainly in all the truly international ones there is strong competition, and customers make banks and securities houses bid against each other before they place contracts. A company could do its banking with one company and its securities business with another. If new entrants, such as banks, come into the securities business, then that will increase the competition and thus increase the likelihood that the customer will get the best service at the right price. Since neither banks nor securities houses have monopolies of their industry, increasing entrants intensify competition and provide the opportunity for customers to pick and choose among a yet wider number of financial institutions. Under those circumstances, the chance of conflicts of interest leading to abuse of the customer's position is relatively small.

Banks and securities houses are both brought up in the culture of recognising their fiduciary responsibilities. The open pricing of securities trades gives the customer evidence with which to check whether he is being abused in the pricing of the services he receives. Modern technology has in many ways enhanced the position of the customer, because the prices of securities are now displayed on television screens throughout the market. A customer would soon know, and take his business elsewhere, if a financial institution dealt at prices which differed significantly from those on the screen. Indeed, we have evidence that customers monitor extremely closely the price at which, for example, foreign exchange and securities trading is done on their behalf, and make their views well known if they feel they have cause for complaint.

As already indicated, most institutions are taking the step of employing compliance officers to ensure that their organisation satisfies the full range of modern supervisory requirements. In London, for example, the move to a more liberal market structure is being associated with the substantial intensification of supervisory procedures, precisely with the view to ensuring that the customers position is not abused.

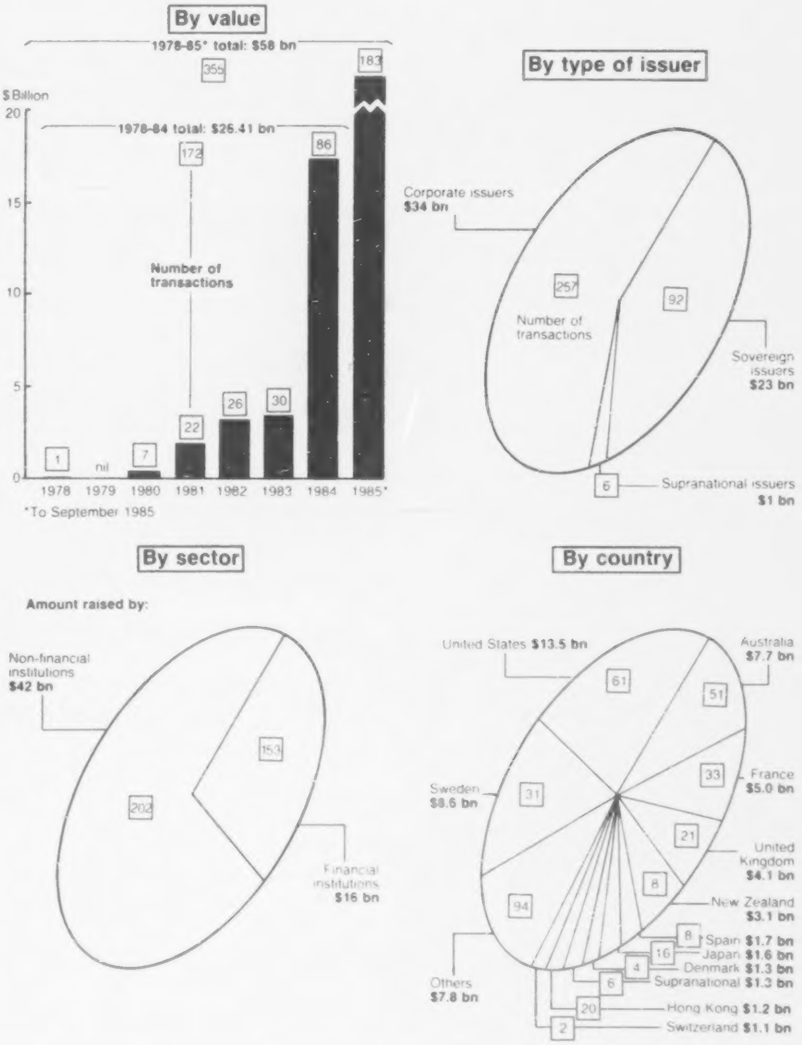
Modern developments such as the increasing intensification of competition, the much wider dissemination of price information, and the intensification of supervision and the financial penalties for unacceptable activity, create an excellent environment for ensuring that any such abuses are minimal.

Above all the future prosperity of any major financial institution depends on its reputation for integrity and I am sure we are not alone in regarding this as our first priority.

Tables

Euronotes: Charting the market

Volume, 1978 - Sept 1985 (signed facilities only) Total: $58 bn, 355 transactions



By value

By type of issuer

By sector

By country

Source: Euromoney

Table 1

Funds Raised on the International Capital Markets

	$ Billion				
	1981	1982	1983	1984	1985*
International Bonds	31.3	50.3	50.1	81.7	131.2
Foreign Bonds	21.3	25.2	27.0	27.8	28.5
Other Bonds	1.0	—	—	2.0	1.8
Total Bonds	53.6	75.5	77.1	111.5	161.5
(of which FRNs & CDs)	(11.3)	(15.3)	(19.5)	(38.2)	(57.3)
International Bank Loans	94.6	98.2	67.2	56.8	43.9
Other Facilities (mainly NIFs and RUFs)	14.0	5.4	9.5	27.3	36.5
Merger Related Standbys	39.1	—	4.0	26.5	—
Total	201.3	179.1	157.8	222.1	241.9
Percentages:					
Bonds/Total	26.6	42.2	48.9	50.2	66.8
Bank Loans/Total	47.0	54.8	42.6	25.6	18.1
Other Facilities/Total	26.4	3.0	8.5	24.2	15.1

* January - September at annual rate

Source: OECD, 'Financial Market Trends'.

Table 2

Top 20 arrangers — by volume

January-September 1985

Rank	Bank	Amount ($m)	No of transactions
1	CSFB	4 965	23
2	BankAmerica Capital Markets Group	4 610	11
3	Merrill Lynch Capital Markets	4 045	22
4	Salomon Brothers International	3 130	8
5	Citicorp	3 025	17
6	Chase Manhattan Capital Market Group	2 800	7
7	Bankers Trust	2 750	12
8	Morgan Guaranty	2 505	12
9	Bank of Tokyo International	1 400	3
10	SG Warburg & Co	1 260	8
11	Goldman Sachs Ltd	1 225	6
12	Enskilda Securities	1 165	14
13	Manufacturers Hanover	1 086	9
14	Swiss Bank Corp International	950	3
15	Societe Generale	852	2
16	Lloyds Bank International	842	6
17	Schroders	659	8
18	Chemical Bank	586	3
19	Morgan Grenfell & Co	570	5
20 =	Dean Witter Capital Markets — International	550	2
30 =	Orion Royal Bank	550	2

Top 10 arrangers — by number of transactions

Rank	Bank	Amount ($m)	No of transactions
1	CSFB	4 965	23
2	Merrill Lynch Capital Markets	4 045	22
3	Citicorp	3 025	17
4	Enskilda Securities	1 165	14
5 =	Bankers Trust	2 800	12
5 =	Morgan Guaranty	2 750	12
7	BankAmerica Capital Markets Group	4 610	11
8	Manufacturers Hanover	1 086	9
9 =	Salomon Brothers International	3 130	8
9 =	Schroders	659	8
9 =	SG Warburg & Co	1 260	8

Top 20 underwriters — by volume

Rank	Bank	Amount ($m)	No of transactions
1	Banque Nationale de Paris	765.6	44
2	Orion Royal Bank/RBC	695.8	43
3	Credit Suisse	617.7	36
4	IBJ	612.1	46
5	Sumitomo Bank/Sumitomo Finance	576.8	37
6	BankAmerica Capital Markets Group	560.5	28
7 =	Bankers Trust	553.7	34
7 =	Toronto Dominion	531.7	24
9	Credit Lyonnais	491.7	39
10	Swiss Bank Corp/SBCI	489.7	25
11	Banque Paribas	450.2	39
12	Amsterdam-Rotterdam Bank NV	448.7	24
13	Algemene Bank Nederland	493.3	24
14	Bank of Montreal	420.7	18
15	Westpac Banking Corp	401.4	30
16	First Interstate	392.9	16
17	CIBC Ltd	389.6	26
18	Citicorp	378.4	34
19	Bank of Tokyo	368.6	24
20	NatWest/County Bank	357.6	19

Top 20 tender panellists — by number of transactions

Rank	Bank	Amount ($m)	No of transactions
1	Citicorp	550.9	69
2	Merrill Lynch Capital Markets	638.4	56
3	Bankers Trust	433.1	52
4	Banque Paribas	364.2	49
5	Banque Indosuez	276.6	47
6 =	Sanwa Bank	322.2	46
6 =	CSFB	546.0	46
8 =	Orion Royal Bank/RBC	527.2	42
8 =	Salomon Bros International	566.5	42
8 =	Schroders	263.9	42
11	BankAmerica Capital Markets Group	463.2	42
12 =	Sumitomo Finance International	400.5	40
12 =	Chase Manhattan Capital Markets Group	380.9	40
14	Swiss Bank Corp/SBCI	466.6	38
15 =	Banque Nationale de Paris	415.7	36
15 =	IBJ	439.0	36
17	Credit Lyonnais	349.8	35
18 =	Goldman Sachs International Corp	474.2	33
18 =	Dai-Ichi Kangyo Bank	288.8	33
18 =	Lloyds Bank International	217.7	33

Source: Euromoney Capital Markets Guide

Table 3

Eurobonds — Top 50 bookrunners

All issues in all currencies

January-September 1985 compared to same period in 1984

All bookrunners receive full amounts of each issue

Rank		Bookrunners	1985			1984		
1984	1985		No of Issues	Amount (US$m)	Share %	No of Issues	Amount (US$m)	Share %
1	1	Credit Suisse First Boston	80	16,354.8	16.5	53	8,961.5	17.2
5	2	Salomon Brothers International	50	5,614.5	5.6	21	2,633.6	5.1
6	3	Merrill Lynch	34	5,304.7	5.3	16	2,034.6	3.9
3	4	Morgan Guaranty	42	4,810.2	4.8	25	3,450.7	6.6
12	5	Goldman Sachs	33	4,791.4	4.8	11	1,148.4	2.2
2	6	Deutsche Bank	45	4.713.9	4.7	44	4,344.2	8.3
4	7	Morgan Stanley	43	4,062.8	4.1	29	3,230.6	6.2
7	8	Nomura Securities	46	3,537.0	3.6	24	1,605.5	3.1
17	9	Orion Royal Bank	44	2,704.3	2.7	14	894.3	1.7
29	10	Union Bank of Switzerland	19	2,600.7	2.6	6	490.7	0.9
10	11	Banque Paribas	42	2,558.8	2.6	11	1,225.7	2.4
14	12	Daiwa Securities	27	2,175.2	2.2	18	1,026.4	2.0
20	13	Bankers Trust	21	2,098.1	2.1	5	720.0	1.4
11	14	SG Warburg	15	2,051.6	2.1	15	1,198.0	2.3
25	15	Yamaichi Securities	27	1,875.7	1.9	11	520.0	1.0
13	16	Shearson Lehman Bros International	11	1,866.4	1.9	9	1,065.0	2.0
24	17	Bank of America	7	1,844.7	1.9	2	530.0	1.0
16	18	County Bank	8	1,827.0	1.8	5	954.0	1.8
22	19	Samuel Montagu	6	1,768.4	1.8	7	572.3	1.1
9	20	Banque Nationale de Paris	13	1,615.2	1.6	9	1,358.2	2.6
21	21	Swiss Bank Corporation	16	1,550.0	1.6	6	652.8	1.3
33	22	Societe Generale	15	1,414.5	1.4	4	425.4	0.8
43	23	Citicorp	11	1,395.2	1.4	3	220.0	0.4
27	24	Lloyds	6	1,325.0	1.3	2	516.7	1.0
23	25	Credit Commercial de France	16	1,319.9	1.3	7	532.3	1.0
18	26	Commerzbank	20	1,319.0	1.3	14	820.4	1.6
8	27	Dresdner Bank	18	1,252.9	1.3	16	1,389.5	2.7
15	28	Nikko Securities	22	1,186.2	1.2	16	978.8	1.9
37	29	Barclays Bank Group	6	1,132.2	1.1	1	350.0	0.7
39 =	30	Chase Manhattan	10	973.5	1.0	3	250.0	0.5
26	31	Credit Lyonnais	9	972.3	1.0	5	516.7	1.0
19	22	Morgan Grenfell	12	756.1	0.8	11	743.5	1.4
34	33	Industrial Bank of Japan	8	717.4	0.7	4	400.0	0.8
—	34	Bank of Tokyo	10	664.3	0.7	—	—	—
42	35	Schroder Wagg	6	653.0	0.7	2	228.2	0.4
28	36	Wood Gundy	11	589.6	0.6	11	499.7	1.0
50	37	Long-Term Credit Bank of Japan	8	570.7	0.6	1	125.0	0.2
—	38	Mitsubishi Bank	6	548.6	0.6	—	—	—
31	39	Manufacturers Hanover	7	501.2	0.5	5	460.0	0.9
32	40	Hambros Bank	12	435.7	0.4	6	457.3	0.9
36	41	WestLB	7	364.0	0.4	8	364.8	0.7
30	42	Amsterdam-Rotterdam Bank	12	350.0	0.4	10	489.5	0.9
56 =	43	Kidder Peabody	4	332.8	0.3	1	100.0	0.2
41	44	Baring Brothers	5	304.9	0.3	2	236.0	0.5
44	45	BHF-Bank	7	285.9	0.3	4	179.6	0.3
67	46	Kleinwort Benson	4	280.0	0.3	1	44.7	0.1
60	47	Sumitomo Bank	2	270.0	0.3	1	75.0	0.1
—	48	Mitsui Bank	2	250.0	0.3	—	—	—
49	49	Banque Bruxelles Lambert	7	235.6	0.2	2	125.1	0.2
—	50	Sanwa Bank	3	232.5	0.2	—	—	—

Source: Euromoney Capital Markets Guide
Note Separate warrant issues excluded

Table 4

Eurobonds — Bookrunning rankings by sector

Floating rate notes — Top 20 banks

January-September 1985 compared same period in 1984

Rank 1984	Rank 1985	Bookrunners	1985 No. of issues	1985 Amount (US $m)	1985 Share %	1984 No. of issues	1984 Amount (US $m)	1984 Share %
1	1	Credit Suisse First Boston	30	11,434.7	27.9	28	4,971.0	24.9
3	2	Merrill Lynch	18	3,530.0	8.6	8	1,340.0	6.7
2	3	Morgan Guaranty	13	2,941.2	7.2	10	2,178.9	10.9
5	4	Salomon Brothers International	17	2,275.0	5.5	4	858.6	4.3
9	5	Bank of America	7	1,844.7	4.5	2	530.0	2.7
17 =	6	Samuel Montagu	4	1,678.9	4.1	3	350.0	1.8
6	7	County Bank	5	1,583.5	3.9	4	854.0	4.3
10	8	Lloyds Bank International	3	1,180.0	2.9	2	516.7	2.6
12 =	9	Shearson Lehman Bros International	4	1,120.0	2.7	3	450.0	2.3
25	10	Citicorp	5	996.2	2.4	2	150.0	0.8
12 =	11	Bankers Trust	5	915.4	2.2	2	450.0	2.3
7	12	Morgan Stanley	5	850.0	2.1	6	735.0	3.7
27 =	13	Goldman Sachs	5	825.0	2.0	1	100.0	0.5
19	14	Credit Commercial de France	5	762.0	1.9	2	335.7	1.7
26	15	Orion Royal Bank	3	730.0	1.8	2	135.0	0.7
4	16	Banque Nationale de Paris	3	650.0	1.6	3	1,050.0	5.3
21 =	17	Société Générale	4	640.0	1.6	1	250.0	1.3
14	18	Crédit Lyonnais	3	633.3	1.5	2	425.0	2.1
21	19	Banque Paribas	5	623.7	1.5	2	250.0	1.3
16	20	SG Warburg & Co	5	632.4	1.5	3	368.4	1.8

Fixed-rate issues — Top 20 banks

Rank 1984	Rank 1985	Bookrunners	1985 No. of issues	1985 Amount (US $m)	1985 Share %	1984 No. of issues	1984 Amount (US $m)	1984 Share %
3	1	Credit Suisse First Boston	43	4,220.5	7.7	23	2,490.5	8.7
1	2	Deutsche Bank	42	4,051.9	7.4	39	3,905.2	13.7
6	3	Goldman Sachs	26	3,531.4	6.5	10	1,048.4	3.7
4	4	Salomon Brothers International	33	3,339.5	6.1	17	1,775.0	6.2
2	5	Morgan Stanley	36	3,097.8	5.7	23	2,495.6	8.7
9	6	Nomura Securities	34	2,673.5	4.9	13	792.2	2.8
24	7	Union Bank of Switzerland	18	2,425.7	4.5	4	340.0	1.2
10	8	Orion Royal Bank	41	1,974.3	3.6	12	759.3	2.7
7	9	Banque Paribas	37	1,926.2	3.5	9	975.7	3.4
5	10	Morgan Guaranty	29	1,869.1	3.4	15	1,271.9	4.4
13	11	Merrill Lynch	16	1,774.7	3.3	8	694.6	2.4
26	12	Yamaichi Securities	23	1,715.7	3.1	7	320.0	1.1
14	13	Daiwa Securities	17	1,512.6	2.8	12	693.3	2.4
8	14	SG Warburg & Co	10	1,419.2	2.6	12	829.6	2.9
19	15	Swiss Bank Corporation	14	1,400.4	2.6	4	417.8	1.5
28	16	Bankers Trust	16	1,182.7	2.2	3	270.0	0.9
12	17	Dresdner Bank	17	1,092.0	2.0	13	714.5	2.5
27	18	Banque Nationale de Paris	10	965.2	1.8	6	308.2	1.1
18	19	Nikko Securities	15	858.7	1.6	8	478.8	1.7
11	20	Commerzbank	15	826.7	1.5	13	720.4	2.5

Convertibles — Top 5 banks

Rank 1984	Rank 1985	Bookrunners	1985 No. of issues	1985 Amount (US $m)	1985 Share %	1984 No. of issues	1984 Amount (US $m)	1984 Share %
1	1	Credit Suisse First Boston	7	699.6	17.7	2	1,500.0	42.1
6	2	Daiwa Securities	10	662.6	16.8	4	158.0	4.4
2	3	Nomura Securities	8	473.5	12.0	8	600.0	16.9
—	4	Goldman Sachs	2	435.0	11.0	—	—	—
3	5	Nikko Securities	7	327.5	8.3	8	500.0	14.0

Source: Euromoney Capital Markets Guide

All bookrunners receive full amounts of each issue

Table 5

Financial Institutions' Shareholdings in UK Brokers and Jobbers

Date	Financial Institution/Bank	Stockbroker (S) or Jobber (J)	Holding = (£1 million)
Jun 82	Security Pacific (see May 85)	Hoare Govett (S)*	£8.1 29.9% (plans 80-90%)
Nov 82	J Rothschild Holdings	Kitcat and Aitken (S) (sold in Feb 85)*	£0.5 29.9%
Nov 83	Citicorp	Vickers da Costa (S) (+80% of Far East Ops)*	£20.0 29.9% (plans 100%)
Nov 83	White & Red Rose Investments	Wishart Brodie (S)	10%
Nov 83	Mercury International Group (Warburg)	Akroyd and Smithers (J)*	£41.0 29.9%
Dec 83	Hawley Group	Fyshe Horton Finney (S)	29.9%
Dec 83	N M Rothschild	Smith Brothers (J)	£6.5 29.9%
Jan 84	Mercury International Group	Rowe and Pitman (S) (and see Aug 84)	£16.2 29.9%
Feb 84	National Westminster Bank	County Bisgood Ltd (J)*	29.9% (plans 100%)
Mar 84	Barclays Bank	Wedd Durlacher Mordaunt (J)*	£30.0 29.9% (plans 75%)
Mar 84	Barclays Bank	de Zoete and Bevan (S)*	5% (plans 75%)
Mar 84	Samuel Montagu (subsidiary of Midland) (60%) and Aetna Insurance (USA) (40%)	W Greenwell (S)*	29.9% (plans to raise to 50%)

Contd

Table 6

Financial Institutions' Shareholdings in UK Brokers and Jobbers Contd

Date	Financial Institution/Bank	Stockbroker (S) or Jobber (J)	Holding = (£1 million)
Mar 84	Hambros	Strauss Turnball (S)	29.9% (may increase to 50%, but not 100%)
Apr 84	Morgan Grenfell	Pinchin Denny (J) + 5% Pember and Boyle (Oct 84)	29.9% (plans 100% of both)
Apr 84	Skandia (Swedish Insurance Co)	Quilter Goodison (S)	29.9%
Apr 84	Guinness Mahon	White and Cheeseman (J)	29.9%
Apr 84	Security Pacific	C T Pulley (J)	5.0% (plans 100%)
May 84	Mercantile House (through Alexanders Laing and Cruickshank Holdings)	Laing and Cruickshank (S)*	£7.5 29.9% (plans 100%)
May 84	Exco (see Feb 85)	Galloway and Pearson (S) (new name is WICO Galloway and Pearson)	29.9% (plans 100%)
May 84	Baring Brothers	Henderson Crosthwaite (Far East) (S)	77.0%
Jun 84	Kleinwort Benson	Grieveson Grant (S)	5.0% (£2.2m) (plans 100%)
Jun 84	Granville and Co	R A Coleman (S)	29.9% (plans 100%)
Jun 84	Hill Samuel	Wood Mackenzie (S)*	£5.9 29.9% (plans 100%)
Jul 84	Bache Group Inc	P B Securities, Down de Boer and Duckett (S) (new firm)*	29.9% (plans 100%)

Contd

Table 6

Financial Institutions' Shareholdings in UK Brokers and Jobbers Contd

Date	Financial Institution/Bank	Stockbroker (S) or Jobber (J)	Holding = (£1 million)
Jul 84	National Westminster Bank	Fielding, Newson-Smith (S)*	5.0% (plans 100%)
Jul 84	Shearson Lehman (Insurance Co) plus American Express	L Messel (S)*	5.0% (plans 100%)
Jul 84	Grindlays Holdings (Australia and New Zealand Banking Group)	Capel-Cure Myers (S)	5% (plans 29.9% by Apr 85 and thence 100%)
Aug 84	Mercury International Group (parent of S G Warburg) (see Jan 84 Charter Consolidated will retain a stake)	Akroyd and Smithers (J)/Rowe and Pitman (S)/ Mullens (S)*	Market capital £350
Aug 84	Lancashire and Yorkshire Investment Co	Battye, Wimpenny and Dawson (S)	25.0% (+4.9% option)
Aug 84	Schroder Wagg	Helbert Wagg and Co (S) (new firm) (plus Anderson Bryce Villiers)	29.9% (plans 100%)
Sept 84	Citicorp	Scrimgeour Kemp-Gee (S)*	29.9% (plans 100%)
Sept 84	Dow Scandia	Savory Milln (S)	29.9% (plans 100%)
Sept 84	Hongkong and Shanghai Banking Group	James Capel (S)*	£25 29.9% (plans 100%)
Oct 84	Morgan Grenfell (see Apr 84)	Pember and Boyle (S)	5.0% (plans 100%)
Oct 84	Kleinwort Benson	Charlesworth and Co (J)*	£0.8 29.9% (plans 100%)

Contd

Table 6

Financial Institutions' Shareholdings in UK Brokers and Jobbers Contd

Date	Financial Institution/Bank	Stockbroker (S) or Jobber (J)	Holding = (£1 million)
Nov 84	Union Bank of Switzerland	Phillips and Drew (S) (and see Apr 85 entry)	29.9% ($100m) (plans 100%)
Nov 84	Chase Manhattan	Laurie, Milbank (S) (plus Simon and Coates)*	£30 (plans 100%)
Nov 84 (agreement abandoned May 85)	Britannia Arrow	Heseltine Moss (S)	29.9% (planned 100%)
Dec 84	Exco International	Laurie, Milbank (S) (money-broking operation)	£10
Dec 84	NCNB Corporation (Florida based subsidiary is Carolina Bank)	Panmure Gordon (S)	29.9%
Dec 84	N M Rothschild (through Smith Brothers)	Scott Goff Layton (S)	5.0%
Dec 84	Banque Bruxelles Lambert	Williams de Broe Hill Chaplin (S)	29.9% (plans 66.7%)
Dec 84	Baring Brothers	Wilson and Watford (J)*	29.9% (plans 100%)
Jan 85	Credit Suisse	Buckmaster and Moore (S)	29.9% (plans 85%)
Jan 85	N M Rothschild (see Dec 83)	Smith Brothers (J) increasing stake to 24% (assuming conversion ordinary shares and £5.65 million)	36.6%
Feb 85	Exco	WICO Galloway Pearson (29.9% owned by Exco) are buying Walter Walker (S)	29.9%

Contd

Table 6

Financial Institutions' Shareholdings in UK Brokers and Jobbers Contd

Date	Financial Institution/Bank	Stockbroker (S) or Jobber (J)	Holding = (£1 million)
Feb 85	Orion Royal Bank (sub of Royal Bank of Canada)	Kitcat and Aitken (S) The 29.9% holding by J Rothschild Holdings sold to Orion (see Nov 82)*	29.9% (plans 100%)
Feb 85	BAII Group (Banque Arabe et Internationale d'Investissement)	Sheppards and Chase (S)	29.9% (plans 100%)
Apr 85	Union Bank of Switzerland	Moulsdale (J), bought through Phillips and Drew (UBS own 29.9% of P and D - see Nov 84)*	5.0% (plans 100%)
Apr 85	Canadian Imperial Bank of Commerce	Grenfell & Colegrave (S)	5.0% (plans 100%)
May 85	Security Pacific (through Hoare Govett)	Trevor Matthews and Carey (Channel Isles stockbroker)	Hoare Govett to acquire majority holding
May 85	Save and Prosper (unit trust group)	Montagu Loebl Stanley (S)	5.0% Apr 86, taking 100% later in 86
May 85	Girozentrale (second largest Austrian bank)	Gilbert Elliot and Co (S)	29.9%, rising to 75% in 86 and 100% eventually
May 85	FBD Insurance (Irish)	Maguire and McCann Morrison and Co (S)	29.9%
Jun 85	Credit Commercial de France and Framlington	Laurence Prust (S)	Approx 80% planned
Jun 85	Merrill Lynch	A B Giles and Cresswell (J)*	29.9%

Contd

Table 6

Financial Institutions' Shareholdings in UK Brokers and Jobbers Contd

Date	Financial Institution/Bank	Stockbroker (S) or Jobber (J)	Holding = (£1 million)
Jul 85	Citicorp	J and E Davy (S) (LSE member, based in Dublin)	29.9%
Jul 85	1. Hongkong and Shanghai Banking Corp (through James Capel) 2. PosTel Investment Management	Parsons and Company (S) (Glasgow based)	HS and PosTel are each taking 20%
Jul 85 (see Mar 84)	Midland Bank/Samuel Montagu bought out Aetna's 40% share	W Greenwell (S)*	29.9% (plans 100%)
Aug 85	Mercantile House (by merging CWPT with N Ireland office of Laing and Cruickshank)	Carr Workman Patterson Topping (S) (in Belfast)	Merger

* Among 29 financial institutions which will be allowed to deal in the reformed market for UK Government securities.

Source: Noel Alexander Associates

Table 6

Gilt-Edged Market Makers

Others

Bank of America

BT Gilts, a subsidiary of Bankers Trust bank

James Capel Gilts, owned by broker James Capel

Chase, Laurie and Simon, a subsidiary of Chase Manhattan Bank

Citicorp Scrimgeour Vickers, a subsidiary of Citicorp

CSFB (Gilts), part of the Swiss bank Credit Suisse, and the US investment house, First Boston

Goldman Sachs Government Securities (UK), incorporated in Goldman Sachs, the US investment bank

Hoare Govett Sterling Bonds, a subsidiary of Hoare Govett, brokers, which is soon to link with Security Pacific

Merrill Lynch, Giles and Cresswell, a subsidiary of the US securities group Merrill Lynch

Messel/Shearson Lehman, a UK securities business based around the broker L Messel, by Shearson Lehman/American Express

Morgan Guaranty Gilts

Orion Royal Bank/Kitcat and Aitken, a UK securities business which is part of the Royal Bank of Canada's merchant banking dept

Phillips and Drew Moulsdale, owned by the British broker Phillips and Drew, soon to merge with the Union Bank of Switzerland

Prudential-Bache, US securities house, in a joint venture with Clive Discount, British discount house

Salomon Brothers, UK, a subsidiary of the US investment bank, Salomon Brothers

Table 7

Gilt-Edged Market Makers

British Owned

Aitken, Cambell and Co (Gilts), part of the Scottish stock jobbing firm, Aitken Cambell

Akroyd, Rowe and Pitman, Mullens and Co, part of the UK investment bank, Mercury International

Alexanders, Laing and Cruickshank, a member of the British financial group, Mercantile House

Barclays de Zoete Wedd, a subsidiary of Barclays Bank

Baring, Wilson and Watford, fully-owned by the British merchant bank, Baring Brothers

Cater Allen Holdings, discount house

County Holdings Group, owned by National Westminster Bank

Gerrard and National, discount house

Greenwell Montagu Gilt-Edged, representing Midland Bank

Hill Samuel Wood Mackenzie (Sterling Debt), a subsidiary of Hill Samuel, the merchant bank

Kleinwort, Grieveson, Charlesworth, fully-owned by the merchant bank, Kleinwort Benson

Lloyds Bank Group

Morgan Grenfell Government Securities, owned by the British merchant bank, Morgan Grenfell

Union Discount Securities, discount house

Table 7

Sir **Martin Jacomb**. Senator Garn, just as you rightly started with, congratulations to Mr. Villiers on the formality and elegance of his evidence, I have to start with an apology, which is due to the fact that I only got your letter on Friday. And, therefore, I haven't got formal evidence to anything like the same standards. So what I'd really like to do——

The **Chairman**. Well, we'll average it out, between the very formal and the——

[Laughter.]

Sir **Martin Jacomb**. That's what I'd like to do, because what I'd really like to do is just to make a few informal observations, which I think——

The **Chairman**. I understand about the mail. I have a son living in England and some days, sometimes, it takes 2 weeks to get a letter from him. This week, I got one in 3 days. So, you never know.

Sir **Martin Jacomb**. Right. Well, what I'd like to do is just to keep my observations rather short and rather informal.

STATEMENT OF SIR MARTIN JACOMB, EXECUTIVE CHAIRMAN, BARCLAYS MERCHANT BANK, LONDON, ENGLAND

Sir **Martin Jacomb**. Well, what I'd like to do is just keep my observations rather short and rather informal. I think the basic issue is really very straightforward. It is how to achieve the economic deployment of capital for the benefit of those who want to raise capital and those who want to invest on a worldwide basis.

I think the aims right here in the United States, as elsewhere, have to be to try and promote competition to the maximum possible extent to give the maximum benefit both to investors and to those who want to raise capital.

And if you look at the Eurocurrency bond market about which you've heard a lot today, you can see banks competing with securities houses head on, which operates to the benefit of both borrowers and investors.

REGULATION ON THE SECURITIES MARKET

The U.S. regulatory system cuts out the competition from banks to a very large degree in the securities market, which is extremely important today—much more important today than it was, say, 10 years ago because, today, the securities business needs a great deal more capital than it did 10 years ago. And by eliminating the banks from a lot of the competition with the securities industries, you are eliminating a large amount of the capital which otherwise would be behind the securities business. And to that extent, you are restricting competition to the detriment of both those who want to raise capital and those who want to invest.

Of course, the industries remain highly competitive, but they're not as competitive in the United States as they are in Europe in the Eurocurrency bond market for that reason.

So one objective which I'm sure you and your committee would be wanting to achieve is to try and ensure the maximum competition for the benefit of the people who the securities industry is trying to serve.

The other objective, which is much harder and which you and your colleagues have addressed a lot of questions in relation to, is how to protect investors.

The safety for investors depends on a number of factors but one factor it depends on is adequate capitalization, so that when there is a real accident, the house responsible for it has enough capital to safeguard the customers from the risk of loss.

And that is another reason why banks' involvement in the securities industry today is probably a desirable thing.

Another factor in trying to prevent the risk of loss, which is an essential part of protecting investors is the existence of a regulatory system which minimizes the risk of serious loss by financial intermediaries.

There is experience outside the United States that has shown that you can regulate the securities operations of banks just as well, even though they are within the same organization, as you can by separating the two activities one from the other.

The universal banks in Germany and Switzerland provide perfectly good examples of that, and we also have exactly the same example and experience in London. And we're going to go much further into that direction with the so-called big bang changes which affect the London Stock Exchange.

So, in the United Kingdom, we are not afraid of the trend to universal banking in the sense that we believe that it's perfectly possible to have a system of regulating those banks and the securities activities which they undertake in a perfectly adequate way to prevent the banks themselves suffering losses so great that they then endanger their customers.

So we don't see the need to separate the securities from the banking business as a necessary step in protecting banks from the risks which ensue from their own folly.

Accidents, of course, do happen. They happened, for example, at Herstadt in Germany. They happened in Chiasso with the Credit Swisse in Chiasso (phonetic). Accidents do happen, and they happen here even in the United States, in incidents like the Drysdale Securities incident.

But they do not happen in ways which would have been prevented by the separation of banking—that is, deposit taking—from the securities business.

One then goes further—and this is the part of regulation which must be of particular concern to you and your committee—to consider the form of regulation, insofar as it directly affects investors. A great deal has been said this morning—I am afraid what I am about to say may sound slightly heretical—a great deal has been said this morning about the competition between various centers in the standards of regulation, implying that a lower standard of regulation attracts business because it is cheaper and easier to deal with.

Personally, I think that is a fallacy. A concrete example which might be of help to you and the committee is what happened in the commodities markets not long ago, when there was a tremendous strengthening of the regulatory environment affecting the commodities markets right here in the United States in order to protect investors, a trend, an event, which personally I greatly applaud. In

London there was a general belief at that time that those steps would lead to a great deal more business in London because the regulatory climate affecting the commodities markets then was exceedingly lax.

In fact, nothing of the kind occurred. The business did not flow to London. It stayed in the United States and greatly expanded so long as investors were interested in commodities; and the only reason that it has tailed off since is because inflation itself has tailed off and lessened the interest in that area.

But that is a very concrete example of business not being attracted to the lowest common regulatory denominator. And in fact the Eurocurrency bond market also provides a different but equally interesting example, which is this: That what attracts people to the Eurocurrency bond market is not the absence of regulation.

INTEREST EQUALIZATION TAX

The thing is the Eurocurrency bond market, started because of the interest equalization tax way back in the beginning of the sixties. That is what led to it. It was a tax advantage and not a regulatory advantage. The regulatory advantage may have been a nice additional advantage, but it wasn't the primary reason for the market.

And what keeps the Eurodollar bond market up to the standards which it has is the fact that you can't make an issue at all on the Eurodollar bond market unless the underwriting group is led by a really high-class lead underwriter with a high-class management group.

Incidentally, just to give you some background on just how well the Eurodollar bond market has worked, I think it is true to say that there have been 8,000 issues since that market began. There are 4,000 currently in issue.

And although in my letter to you, which was written by the fireside on Sunday afternoon, I said I could only think of two issues the issues of which have failed, in fact, I think the figure I have now worked out is a dozen.

But only a dozen failed issues out of 8,000 shows you how well that market has operated. But—in my opinion, it does not operate in such a way because it is free of regulation, as I have tried to show with the commodities example.

I ought to have said as I began this testimony that in regard to my own background I am, I suppose, a jack of all trades, and if you ask me any questions, you will probably discover I am a master of none.

I spent some 17 years of my life with Merchant Bank in London, with a very large business here in the United States, including the ownership of one of the U.S. primary Government bond dealers, which was under the securities side of the Glass-Steagall Act; I now am with Barclays Bank, which is under the banking side of the Glass-Steagall Act.

But one of my other responsibilities is that I am deputy chairman of the Securities and Investments Board, which is our emerging practitioner-based equivalent of the SEC; and we take the view there that the competition is going to be a competition for the highest standard of regulation between the various self-regulatory organizations that we shall be supervising, and we believe that the higher the standards of regulations are, the more those bodies will attract the business, rather than the reverse way around.

I would just like to turn finally to the question of conflicts of interest. People often refer to conflicts of interest as the reason why regulatory separation of functions is desirable, and in fact of course there are valid arguments to that effect, and it certainly could be said that if you allowed banks to issue securities indiscriminately there would be a tendency—you could say this—there would be a tendency for banks which wanted their banking debt repaid to be enticed to issue securities on behalf of the debtor to raise the money from the public which would then be used to discharge the bank debt. That is the kind of conflict of interest which people might refer to.

But in fact in today's climate, which is totally different from the climate which Senator Carter Glass faced in 1933, with a tremendously high degree of public education, with an enormously informed financial press, and with perfectly adequate methods of regulating the securities business conducted by banks, those kinds of conflicts of interest can easily be accommodated.

And I would just like to finish by—if I have got the time—just by reading just part of the letter which I wrote to you, as it deals with some of the specific questions which you mentioned.

In recent years the banking business has developed so that it merges into the securities business with the so-called securitization of bank debt. You know the reasons which have led to that.

And at the same time, since about the end of the 1970's, when bond markets went through a period of extreme volatility, the Eurocurrency bond market started to concentrate on issuing securities with short maturities, and those two trends have led to those two markets becoming merged at the edges, and it is very important for banks to be able to service their customers by being able to handle the issue those obligations by their customers.

The United Kingdom regulatory requirements hardly restrict the foreign entry and participation by foreign financial institutions into United Kingdom markets. We are extremely hospitable to people coming into London on a basis which enables them to operate in both capacities.

The only exception to this—and this really was a question I think raised by Senator Dodd—the only exception to that that I can think of is that in the case of the relationships between London and Tokyo, where there is a major reciprocity issue, right now—in the sense that the Japanese securities houses want to be able to conduct banking business in London; whereas, they don't want British banks in Tokyo to be able to conduct securities business there.

And that is a head on reciprocity question which is going to be resolved eventually by allowing both centers to accommodate each other's nationals, conducting both businesses. That will be resolved in that way.

But as between the United Kingdon and the United States, history has gone on too far to go back on that, and in London, United

States banks are permitted to engage in all forms of securities activities.

So those kinds of reciprocity questions don't exist between the United States and the United Kingdom, but they do exist elsewhere in the world.

Could I just say one thing about the big bang changes in London? Everybody speaks about regulation being swept away in London and us being embarked on a major course of deregulation.

Actually, in fact that is a fallacy, to this extent: that while we believe in the maximum freedom for financial services companies operating on the professional level between professionals, as far as protecting the retail investor is concerned the trend is in exactly the opposite direction. And with the emergence of the Securities and Investments Board under the financial services bill, we are establishing for the first time a regulatory system which is going to protect retail investors just as severely and I hope just as effectively as your SEC does.

I think I had better leave then—rather than take up your time further, I think I had better leave the rest of what I said in my letter to you to question.

[The complete prepared statement follows:]

[illegible]

EBBGATE HOUSE
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LONDON EC4R 3TS

CONFIDENTIAL

24th February 1986

Senator Jake Garn
Chairman
United States Senate
Committee on Banking, Housing, and
Urban Affairs
Washington DC 20510

Dear Senator Garn

Your letter inviting me to testify on February 26th, 1986 in front of the U.S. Senate Committee on Banking and Urban Affairs unfortunately only arrived on Friday, 21st February. Accordingly, the following remarks can only summarise and indicate the general direction of my comments on the questions you raise in your letter. I hope to be able to amplify these and go into more detail in oral testimony should the Committee so wish.

Background

The internalisation of the financial markets started nearly three decades ago. London has been at the centre of it since its inception. It started with the banking business becoming international, following increasing levels of world trade.

The first significant development in internationalisation of the securities markets was the development of the eurodollar bond market. At first this market was used mainly by large U.S. corporations raising debt. It was attractive to them because of the freedom from interest equalisation tax, and the freedom from SEC regulations was an additional advantage though in my opinion it was not a decisive factor. They were tapping eurodollar balances, i.e. dollar balances owned by non-US persons. The market was and remains unregulated. Although centred in London, the institutions creating and underwriting the new eurocurrency bond issues are mainly non-British. There are British participants, but many of the major international banks participate in it as underwriters also.

The market grew continuously throughout the late 1960s and 1970s and borrowers using it have included major corporations of many nationalities and many sovereign borrowers. The market ceased to be exclusively a U.S. dollar market fairly early on and now comprises transactions in all major currencies.

Although participants in it are largely non-British and the clearing mechanisms are established outside London, i.e. Brussels and Luxembourg, London is nevertheless the most important place where issues are created and underwritten. The reason for this is that London has always been an international centre for international banks. It had and still has a hospitable tax and regulatory climate, and it is in a convenient time zone.

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In recent years the banking business has developed so that it merges into the securities business with the so-called "securitisation of bank debt". The Committee will know of the reasons which have led to increasing securitisation of what otherwise would have been bank credit. The reasons include the fact that margins on lending to credit worthy corporations and institutions have become so thin that banks have had to expand their business to the limits of their capital resources in order to generate sufficient earnings to service their equity; and then turn their attention to satisfying their customers' needs by the issue of their customers' obligations direct to those with the liquid resources to take themup, earning fees in the process. In fact, securitisation of debt means that banks are no longer intermediating between first class borrowers and holders of liquidity.

Allied to this is the fact that during the late 1970s the long term bond market became more volatile and with this volatility it became less attractive for borrowers. The eurocurrency bond market has tended to concentrate on shorter dated obligations and has now merged into the securitised debt market which includes obligations of the shortest duration. The figures in the appendix show some of these trends.

UK Government regulatory requirements hardly affect foreign entry and participation by foreign financial institutions in the UK markets. As stated above the eurocurrency bond market is at the moment unregulated. This has not led to trouble so far; the market is, however, restricted by commercial pressures to first class participants and it would be hard for a financial institution to get together an underwriting group unless it was of the highest reputation. The satisfactory way in which this market has worked can be judged by the fact that there have been over 8,000 issues and as far as I know only two issues have been by issuers who have failed. There are currently over 4,000 issues traded (the others have matured) and the market turnover is several hundred billion dollars per annum.

The "Big Bang" changes which are about to take place in London affect the London Stock Exchange. The eurocurrency bond market is a telephone market not conducted on, or directly connected with, the London Stock Exchange. The nature of the "Big Bang" is explained in a lecture which I gave to the Royal Society of Arts, a copy of which is attached to this letter.

However, there are major regulatory changes occurring in London. It is a coincidence, or largely so, that these changes are occurring at the same time as the changes in the Stock Exchange regulations. The latter make the former more necessary, but the former would have been necessary anyway. The need for the regulatory changes has largely arisen because of some failures of minor investment management businesses which were caused by or involved malfeasance, and by an increasing number of minor equity issues being made outside the Stock Exchange system. The Stock Exchange's own regulatory system has been effective; but because of activities outside it the Government called for a report from Professor Gower which drew attention to the antiquated nature of the regulatory system prevailing in London and it was this report which has led to the changes.

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The regulatory changes are being enacted in the Financial Services Bill which is now going through parliament. Under the Bill, if enacted, the actual process of regulating the securities business in London will be delegated to a practitioner based body now called "the Securities and Investments Board" of which I am Deputy Chairman. Enclosed with this letter is a recent publication by the Securities and Investments Board which sets out the approach to the system of regulation which it will administer.

This new system will affect ~~that~~ the eurocurrency bond markets. Although the eurocurrency bond markets will still be able to trade freely with professionals (which so far is the case) they will be affected if and insofar as the distribution of securities becomes a retail business.

The trend to 24-hour trading is quite marked although it has not got very far. Of course, it already exists in the case of foreign exchange, bullion, US Treasury bonds, and certain leading eurocurrency bonds and other similar securities. However, it has not got very far in the case of equities. Nevertheless trading in equities has become international in the sense that many UK equities are now actively traded in ADR form in New York and more and more major international companies are being listed on the Tokyo Stock Exchange so that they will be traded there also. International trading depends on there being enough two-way business in each financial centre in the security being dealt in. Accordingly the growth of this is a gradual process and can only take place when there is real demand in each centre for the securities in question. Stock exchanges have not been linked up internationally to any significant extent so far.

Policy Implications

The internationalisation of the securities markets follows the increasing dependence of all advanced economies on international physical trade. It has flourished on greatly improved communication both by air and particularly by telecommunication. These trends have generated and then increased the demand for securities other than the domestic securities of each market. Thus British investors have wanted U.S. securities and US investors have wanted Deutsche Mark securities, Japanese investors have wanted US dollar and Deutsche Mark securities and European and US investors have wanted Japanese securities. This trend has been strongly reinforced by destabilisation of exchange rates since in order to preserve real values of capital it has been necessary for investors to diversify and be able to switch the currency in which one's investments are denominated. In addition, the performance of industries in various economies has differed widely and investors have, not unnaturally, wanted to get some of their capital into the most productive economies. The internalisation of the securities markets, whether debt or equity, is thus nothing more or less than the deployment of capital on an international basis. It is wanted by investors and the ability to tap this need by corporations issuing debt or equity clearly cheapens the cost of capital. In other words capital is finding its destination on the most economical basis.

The process is inevitable. It is partly for this reason that in many countries exchange controls have been eliminated. The problems associated with different regulatory environments are significant and they can impede but not interrupt the process. Thus the regulatory environment in the United States is generally considered to be quite severe but nevertheless it does not stop many non-US companies coming to the US market. Although the regulatory hurdles are quite expensive the ability to raise capital outweighs this. As I have said above, the laxer regulatory requirement in the eurocurrency bond market is not the main reason why that market has grown to the extent it has in my opinion.

Communication costs are not an inhibiting factor since the communication costs in real terms when taken together with the ease and excellence of communication systems are not great.

The risks which flow from currency exchange fluctuations are well understood by investors. Sometimes investors deliberately wish to expose themselves to currencies which they believe will strengthen. If they take the reverse stance the hedges available in the foreign exchange markets can insulate them from this risk.

Political instability and possibilities of exchange control restrictions on investment flows are also risks which investors are familiar with and take into account.

Internationalisation does not adversely affect the soundness and stability of the world's financial system. If, however, those managing financial services businesses stray into international markets with which they are not familiar then obviously they are taking risks which they may not fully understand, and losses may ensue.

The biggest risks are those which result from management expanding into areas where they are not fully "at home". Another risk which is implicit in the internalisation is that as banks become fully international, which has happened in the case of the major banks many years ago, they are no longer able to depend for their ultimate solvency, i.e. on a lender of last resort, on the central bank of their mother country. Thus if a US bank accepts deposits in currencies other than US dollars but keeps its capital invested in US securities or other US assets, and then if the US dollar declines in value sharply against the other currencies, the bank will find itself under-capitalised. If it is then incapable of renewing or raising deposits in the markets of those other currencies then trouble will ensue.

There is no doubt in my view that London will continue to develop as one of the three lending world financial centres, the others being Tokyo and, of course, New York. London will not only continue to be the place where eurocurrency securities are issued, but also where equities are issued for sale to investors in continental Europe. This is the so-called "euro-equity" market. The continuance of this trend will depend on London being able to demonstrate that this can be done more efficiently and effectively from London than from, say, Frankfurt, Zurich, Milan, Paris or Amsterdam.

The CHAIRMAN. Thank you.

Mr. Knight.

STATEMENT OF JEFFREY R. KNIGHT, CHIEF EXECUTIVE, THE STOCK EXCHANGE, LONDON, ENGLAND

Mr. KNIGHT. Thank you Mr. Chairman. My name is Jeffrey Knight. I am the chief executive of the London Stock Exchange.

I would start by observing that the inexorable law of such occasions is that he who speaks last finds that practically everything he was going to say gets said before him. So he sits striking through things that he had been going to say.

The CHAIRMAN. Would you pull the mike over? I can hear you because you are talking directly to me, but I doubt if those in back of you can.

Mr. KNIGHT. Thank you. I will do that.

I will not read out the written submission which I have made, but I will make one or two points just to highlight it and to give some little explanation further to what has been said by my colleagues on what is going on, particularly as it affects the stock exchange.

The first point is that London, as others have said, has always been a center which has attracted and engaged in the facilitation of international financing, and to that extent therefore it was no accident that the Eurobond market should have grown up in London.

It has been very well situated in London with a climate which has at the same time been receptive to and conducive to the use of this market by people, by issuers coming from outside the United Kingdon and issues being sold chiefly to takers who are outside the United Kingdom.

But the part played by London in the Eurobond market has been very largely an entrepot role, and as Sir Martin has been saying, the regulatory climate has been appropriate to it and regulation has not been absent from it, from the Eurobond market.

NATURAL SELF-REGULATING STANDARDS

It is described and has been described this morning by other speakers as an unregulated market. Well, in many ways it doesn't have a formal regulatory structure applied to it, but it does have a very natural, self-regulating standard which is applied by those who participate in it. It is the best form of self-regulation, if you like, and there is then some form of formal regulation applied to it when the prospectuses which are issued by companies raising money in the Eurobond market are submitted for listing, which for the most part they do largely to the London Stock Exchange or to the Luxembourg Stock Exchange.

I describe in my written notes the nature of the change taking place in the London Stock Exchange which, in our own terms, is nothing short of a revolution, and I make the point that its origins can be traced back to and its own inevitability can be seen in relation to the deregulation starting here in the United States in the early 1970's, which had the effect of causing U.S. investment banks to broaden their own range of activities, principally to become much more dealer oriented and to spread their activities outside the United States.

And for that reason, the reason purely of competition, the need to compete, the London market is being restructured, and all the features which Mr. Villiers and Sir Martin Jacomb have been describing are being permitted, in distinction to the very separate function, very distinct and separated function which had previously applied in London.

And that of course is most evident in the structure of the stock exchange but applies elsewhere in the financial services industry. Functions which had previously been carried on in separated compartments are being permitted to be merged together.

We heard a great deal earlier from witnesses from the United States about internationalization, and it does seem to me that what was being said is that internationalization is observable in several different respects, one of course that issues are made by companies wishing to raise money outside their own national boundaries, principally in the form of debt but also nowadays increasingly in the form of equity.

And I suppose that the leading equity issues which have been done internationally have in fact been United Kingdom, large United Kingdom companies, of which the British Telecom issue was the leading case. There will be more large United Kingdom issues which will be made using an international syndicated selling approach.

We have heard a great deal about the movement of investment funds outside national barriers, and that is an obvious further feature which comes within the term "internationalization."

And we have heard also about the tendency toward the trading of investment internationally.

Taking that last point, the world has increasingly become a dealer market; that is to say, that around the different major capital markets there are substantial institutions, usually banks, which commit major amounts of financial resources to the trading of and taking positions in investments.

These sort of people are not on the whole ultimate buyers, but the extent to which they intermediate and facilitate the buying of nondomestic securities has increased enormously.

And the decision which the stock exchange in London had to take when it decided just over 2 years ago to abandon the traditional system of dealing was whether it should move to an auction-based system which would be roughly analogous to that of the New York Stock Exchange or whether it should move to a dealer-based system which, again using the analogy of the United States, would be closer to that of the NASD, the NASDAQ system.

The decision was taken on very clear grounds of the history of the stock exchange, which has been accustomed, in any case, to competitive dealing methods of making markets, but also, and most essentially because of the nature of what I have been describing going on round the world, that is to say, the emergence of strong dealer markets.

Our own changes in the stock exchange embrace every feature of the rules of the exchange including, as I describe in my submission, membership and dealing. The changes were precipitated in the first place by a move away from fixed minimum commissions, which have been the regime for the whole of the century previously. But we are, for the time being, remaining with the existing dealing system and the existing commission system, pending the introduction of major new technology.

USE OF TECHNOLOGY

The point I want to emphasize is that reference having been made by a number of other speakers to the influence which information technology, particularly communications technology has on the structure of markets. The London Stock Exchange recognizes that clearly and will, in fact, be making the stock exchange capable of operating without any reference whatsoever to the physical trading floor. We will be capable of running the dealing system, and the information systems which support the dealing system, for 24 hours a day, if they are needed 24 hours a day, but in the first instance, they will only be open for 10 hours a day.

I describe also in my note, the changes to regulation which are taking place, and I think Sir Martin makes a good point in saying that deregulation is not to be taken to indicate the pulling down of the standards of invesor protection which have been put up over a long period of years.

Deregulation is essentially a structural phenomenon and is being accompanied by a much more formalized system of licensing and regulation of firms engaged in investment in the United Kingdom, and the principal change in that regulatory approach is that firms which have previously been able to operate investment in the United Kingdom under an exempt capacity, and for example, I think no less than 38 United Kingdom-New York Stock Exchange member firms which are in London are exempt at the moment from all direct regulation, by virtue, simply, of belonging to an association consisting of those NYC member firms in London. They will all, in future, be subject to licensing, and there will, therefore, be—to use a phrase which I think you use over here as well—a level playing field for everyone in that business.

Market regulation in the United Kingdom has always been provided by the London Stock Exchange, and that will continue to be the case in the first place, particularly for domestic markets, and we are also making arrangements for a more formalized and more visible market in nondomestic securities to take place in the European trading time zone, I should say, with the intention that there should be regulated and clearly visible markets in the leading 200 or 300 stocks. I think Mr. Calvin referred to there being 300, so to speak, world class stocks.

It is manifestly desirable, and a number of Senators have asked questions on this point, it is manifestly desirable that there be a clear international cooperation in regulation. One way in which that might be made manifest is by having reporting of transactions in these leading stocks.

I follow Sir Martin in thinking that regulation doesn't actually drive away business, and we have been very proud of the standard of regulation, the standard of conduct, in London over a long period of time, and we believe that we've been successful because of that standard and not in spite of it.

Mr. Chairman, I think the only other point I want to make is that one of the questions which was contained in your letter referred to off-market trading and on-market trading. Well, I think it is very apparent that a great deal of the trading, and I would distinguish, in that respect, trading from direct investment by, shall we say, U.S. pension funds into European markets. Much of the trading goes on away from the official markets and, therefore, doesn't get measured, doesn't get exposed in any way. And it is desirable that there should be the greatest demand of exposure possible. I believe that trading will only be brought back to the stock exchanges if services are provided by exchanges which are capable of supporting that trading and which are economical. And so we, in the London Stock Exchange, are providing new services, particularly for international trading or settlement, for display of information. You heard Mr. Macklin speak of the arrangement we are making with the NASD to exchange price information. You heard Mr. Calvin speak about some arrangements we are discussing with the New York Stock Exchange for trading of stocks.

A good deal has been said about settlement. My own feeling about that is that talk of a global settlement system is unlikely to be fruitful. People have been dreaming of that for 25 years, and the dreams have come to nothing.

What will make things happen is bilateral links, and bilateral links are being made by the London Stock Exchange with a good many agencies overseas including the NSCC and the Midwest Securities Corp. in the United States and with the depositories. A link is being made with the Philadelphia Stock Exchange for the trading of currency options, and it is, I believe, by the bilateral link that we shall make substantial progress.

On the purely regulatory side, I am inclined to think that some of the speakers, particularly in the earlier panel, who have spoken about regulatory cooperation, have been overly optimistic. I don't believe that much has taken place which is of great practical advantage. I think that the SEC initiative in putting out its release on the possible reciprocal acceptability of prospectuses in the United States, United Kingdom, and Canada is a very good practical step. We do, as practical regulators have talks with SEC officials and officials from other securities commissions from time to time. They are of a sporadic and not enormously practical kind. They are very useful, and I believe that there is a lot of room for much more cooperation, internationally, in the sphere of regulation and not confined either to the statutory commissions.

I believe there is room for more practical cooperation between the self-regulatory, nonstatutory agencies, such as the stock exchanges.

Thank you very much.

[The complete prepared statement follows:]

As to a uniform reporting system, I take it that this is referring to accounting standards. I do not think in the near future we shall have a completely uniform system of accounting standards. Accordingly I think the companies and borrowers who wish to use international markets will tend to report in accordance with the strictest requirements.

It is true that the euromarket participants are aiming to form a self-regulatory organisation under the new regulatory system for securities being developed in London. This will consist of two elements: First the exchange which is basically a telephone market will have to conform to certain standards in order to be recognised as an investment exchange; and secondly the participants themselves will have to form themselves into a self-regulatory body which complies with the requirements laid down by the SIB.

If one was aiming to encourage the development of a truly global equities market rather than allow this to develop on its own an international clearing system would certainly be an advantage. Greater harmony between the regulatory systems and reporting standards would also be an advantage. Standardisation of settlement procedures and harmonisation of other Stock Exchange procedures (which is a long way off) would be a further advantage. These things will probably be demand driven in that as the demand for equities becomes truly international so the systems to service this demand will tend to be developed. One of the changes here is likely to be the dimunition in the importance of stock exchanges based on trading on the floor. Modern communications, and in particular the exchange of computerised information with display of prices combined with dealing procedures, are likely to have this result in both London and in the United States and eventually in Japan, although the process may take some time. As this occurs it will be necessary for the authorities to try and ensure at least two things: One is that the telephone exchanges thus resulting are as effectively regulated as exchanges based on floor trading; and the second is that markets in each location are centralised. The customer, be he corporation raising capital or investor, will only be satisfactorily served if markets are in each centre properly centralised. This achieves liquidity and fair display of prices. Decentralised markets are on the whole less efficient.

An important policy implication which affects both banking and the securities markets is to try and ensure that all the significant participants are affected by basically parallel regulatory requirements in their home countries. By way of example capital requirements for Japanese banks are much laxer than capital requirements for UK banks. The net result of this is that because they can be so much more highly geared than British banks they can lend at extremely fine margins. This pressure takes the form, for example, of Japanese banks being able to secure sterling deposits in London and lend at very fine margins to top class credits. As matters stand today more than a third of all lending to municipal authorities in the United Kingdom is lending by Japanese banks. The same considerations apply to the issue of securities and perhaps the most notable thing to be said about the US is that the prohibition on the banks issuing and distributing securities from their own inventory to investors while investment banks can do this business is one of the only significant centres where this applies in such a rigorous form. It does not apply in the UK, Germany or Switzerland. In Japan, exceptions to Article 65 make the prohibition much less severe than in the U.S.

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The policy implications which arise from internalisation are thus:

a) The need to ensure so far as possible that financial services businesses (whether banks or not) are able to compete with each other in each location on level terms in order to meet their customers' needs. Otherwise one sector (in the U.S., the banks) will find themselves at a disadvantage. In the U.S., in the five years to 1983 the 10 largest investment banks earned an average 27 per cent on their equity while the 10 commercial banks earned only 14 per cent on their equity. This difference is in part accounted for by the profitability of business which the banks cannot but would like to do. Furthermore, it is important now that banking and securities businesses are blurred at the edges to ensure that exposures are subject to a common system of supervision.

b) The desirability of harmonising regulatory requirements in the major international financial centres.

c) The desirability of cooperation between the regulatory authorities to achieve (b).

I hope these observations will be of assistance.

Yours sincerely,

Martin W. Jacomb

Sir Martin Jacomb

THE INTERNATIONALISATION OF CAPITAL MARKETS

Euro-Notes, Euro-Bonds and Euro-Commercial Paper are all forms of securitised debt which compete in one form or another with the traditional syndicated Euro-loans.

Market Volume

Statistics show that the worldwide market volume of these instruments is as follows:-

		$Bn	
	1981	1983	1985
a) Traditional Euro-Loans	95	67	60
b)			
Euro-Bonds	30	45	162
Euro-Notes	5	7	60
Euro-Commercial Paper	NIL	NIL	10
c) US Commercial Paper	130	180	300

The totals shown for 1985 are the figures for the first nine months of the year to September, annualised. The rate of growth of the new instruments can be clearly seen and, it would appear that the increase in the last few months has been substantial.

Pricing

The spreads on Euro-Loans in the past years have fallen in line with the increased competition and can be summarised as follows:-

		Basis Points	
	1981	1983	1985
OECD Area	58	65	43
General average including LDC	80	115	58

However, it should be pointed out that in 1985 a survey showed that the spread on a Euro-Loan to a blue-chip corporate would be as low as 10 basis points. This is very much in line with the average margin on Euro-Notes to top corporates of between 10 and 15 basis points.

London's Position in the Market

It is difficult to accurately quantify London's position in the current securitised debt market but it is clearly the major player with market share of about 75%.

There is huge foreign involvement in this market, particularly from US banks including BankAmerica, Citicorp, Chase Manhatten, Merill Lynch and Salomon Bros. In total it is thought that approximately 60 or 70 foreign banks have a specific commitment in London to the Euro-market although in all over 460 foreign banks are represented in London.

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS

Statement to the Committee
26th February, 1986, by
J.R. KNIGHT
Chief Executive
The Stock Exchange,
London

I am happy to submit this written statement, and to appear before the Committee to testify on the subject of the internationalisation of capital markets.

The London Stock Exchange is properly called The Stock Exchange in Great Britain and the Republic of Ireland, being formed in 1973 on the amalgamation of the regional stock Exchanges in the United Kingdom and the Republic of Ireland. The London Stock Exchange was formally established in 1802. From its earliest years the Exchange was used for the flotation of securities issued by companies and other bodies, the proceeds of which were used overseas. Much of the financing of utilities, railways and commercial ventures in the nineteenth century was done from London, and loans issued by many overseas governments were officially quoted on The London Stock Exchange. To this day, there are debt securities of overseas governments issued in the nineteenth century officially quoted and dealt in on The Stock Exchange.

The Official List of The Stock Exchange today contains equity securities of over 1,850 U.K. and Irish companies, and 440 foreign equity securities, (including 193 U.S. companies). I believe this to be a substantially greater number of equities than may be found listed on any other stock exchange in the world. There are in addition many debt securities issued by overseas governments, quasi-government bodies and other public issuers, and of corporations, listed on The Stock Exchange. Debt securities may be denominated in sterling or in other currencies.

In 1939, a system of controls over foreign exchange was introduced, and remained in force until October 1979. During that period, the ability of U.K. citizens to purchase non-domestic securities was severely limited, and the role of the London market in financing overseas ventures was restricted. Nonetheless, the international trading links which had been built up throughout the history of the Exchange were maintained during the forty years in which the exchange controls applied, and the position of the London market in international financing has been much enhanced since 1979.

The Eurobond market was devised and developed in the early 1960's by London merchant banks and stockbroking houses, but active dealings in Eurobond issues on the floor of the London Stock Exchange or between its members have never been of great numerical significance. Eurobond issues of 1,200 companies are nevertheless officially listed on The Stock Exchange. My colleagues appearing on this Panel representing commercial banking and merchant banking will speak about the development of the Eurobond market.

It is well known that major structural changes are taking place in the financial markets of the United Kingdom at the present time, and it would be relevant to describe these changes and the reasons they are happening.

Member firms of the London Stock Exchange have since early this century been required to act in what has become known as "single capacity"; that is, they must be either brokers, acting only as agent for the client, or jobbers, dealing for their own account as principals. The broker/dealer, familiar in the United States, has not been permitted in the London Stock Exchange. Brokers alone are permitted to deal for the public, and are required to bring all their client orders into the market to be transacted with the jobbers. Jobbers compete between themselves for the business the brokers have to offer by the keenness of their prices. That system is about to come to an end, as I will describe.

Membership of The Stock Exchange is personal and individual, obtained following a lengthy training period and formal examinations. Corporate members are permitted, but must consist substantially of qualified individual members. No one non-member interest is permitted to own more than 29.9% of the equity of a member firm. Until 1982 that figure was 10%. Most member firms have until now been partnerships. That system is also to be changed very shortly.

By Stock Exchange rule established early this century, commissions charged on Stock Exchange transactions have been subject to minimum levels laid down by the Council of The Stock Exchange. That rule, and a number of other Stock Exchange rules which were alleged to be restrictive practices, were the subject of a civil action brought against The Stock Exchange in 1978 by the Office of Fair Trading, a government agency, in the Restrictive Practices Court. The proceedings were discontinued by agreement in 1983, a condition of the agreement being that the rule on minimum commissions would be dropped from The Stock Exchange Rule book by the end of 1986, and that certain other rule changes, chiefly concerned with admission to membership of The Stock Exchange, would be made.

It had been central to the defence of The Stock Exchange's rule on minimum commissions that if it were abandoned, the rules on separation of capacity would be impossible to maintain. The principle of separate capacity trading, which separates the function of principal and agent, was widely regarded as providing a fair and efficient market, in which many conflicts of interest were avoided. The government professed itself anxious to see single capacity maintained. In practice, that has proved impossible, and shortly after the decision that minimum commissions were to be abandoned had been taken, it became clear that the rules on single capacity could not be maintained.

From that point, in the late Autumn of 1983, The Stock Exchange Council has embarked on a series of extensive and radical changes to the rules affecting the structure of membership of The Stock Exchange and the system of trading on The Stock Exchange in both equity securities (stocks), and in government debt issues. The market in government debt securities (gilt-edged) is almost entirely conducted in The Stock Exchange.

From a date later this year - 27th October - all the minimum commission rules will be dropped. From that date also, Stock Exchange firms will be permitted to act in dual capacity, as both broker and dealer, and the dealing system and rules will be entirely changed. That is the date of, and those are the events comprising the "Big Bang" in The Stock Exchange. From a rather earlier date, in fact, 1st March, three days time, the 29.9% rule referred to above will be withdrawn, and Stock Exchange member firms will be permitted to become wholly owned subsidiaries of outside interests. No restriction has been placed on the identity of those controlling shareholders. They may be banks or other kinds of financial institution; and they may be domestic or foreign. Each controlling shareholder is however required to be acceptable to the Council of The Stock Exchange, and will be required to be admitted as an external member of the Exchange. It is expected that almost all of the larger member firms will thereafter be corporations.

In the period since late 1983 contracts have been entered into for the purchase by outside interests of almost all the large member firms of The Stock Exchange, and most of those contracts are with firms in the field of financial services. Several large U.S. banks and broking houses are among those purchasers, and it is to be expected that they will all be admitted to external membership of The Stock Exchange, and their purchase contracts permitted to be completed.

Contemporaneous with the events described above, but quite separate from them (since those events are almost all within the authority of the governing body of The Stock Exchange) the law under which investment business is licenced and controlled is being radically revised. A bill, the Financial Services Bill, is before Parliament and is expected to be enacted later this year. Much public interest in the provisions of this bill has been evinced, and it will have a profound effect on the way investment business is regulated in the United Kingdom.

The provisions of the Bill and its effects will bear upon any person, natural or corporate, having a presence and carrying on investment business in the United Kingdom. It is an important fact about the place of the London financial market in the rapidly expanding international financial services industry that there are so many non-domestic financial companies operating in London. Over 500 overseas banks have a subsidiary or branch office in London. Some 45 member firms of the New York Stock Exchange have a presence in London. Some if not all of these latter firms are expected to seek admission to The Stock Exchange. To the extent that they do not, they will be obliged to join another self-regulatory organisation, or to register directly with the body which will be principally responsible for administering the provisions of the new law, the Securities and Investments Board (S.I.B.).

It may be observed from the short description given above of the changes taking place in the organisation and membership of the London market that the conditions for foreign entry and participation by financial institutions in U.K. securities markets will be at least as liberal as those of the U.S. An important point is that there has never been any restriction on the number of members of The Stock Exchange in the United Kingdom. There are no seats. An entry fee to new corporate members will be charged on a scale with which has been set to have a maximum of £50,000. That is substantially less than the current price of a seat on the New York Stock Exchange.

The first question in Senator Garn's letter of invitation to attend before the Committee asks how the London market has participated in the internationalisation trend. The information given so far in this submission will have gone some way towards answering that question. There can be no doubt about the growth of international investment, although statistics of international securities trading are almost impossible to come by. A great deal of the trading in securities carried on by and between broking and investment banking businesses is carried out "off-market", and volume and value statistics are not recorded. On the other hand, figures for outward investment by U.S. investors will no doubt be available to the Committee: my colleagues on this panel have I think included in their evidence statistics of international investment flows. It is almost unnecessary to observe that a good deal or the growth in international securities business is to be attributed to the readiness evident in the last decade of U.S. investing institutions particularly U.S. pension funds to invest directly in overseas economies and through overseas markets. Since it is customary for the managers of investing institutions to recognise fiduciary obligations towards beneficiaries, a great deal of that investment will have been done through official stock markets, where the determination of prices for securities is visible and reliable.

A series of questions in Senator Garn's letter asks about 24 hour trading systems, and the linking of stock exchanges internationally. The simplest answer is to say that there is no extant "24-hour trading system". But the question can be broken down. Trading in bonds, where prices are determined principally by yield, undoubtedly does take place around the world, around the clock. And such trading is not by any means confined to "international bonds" or Eurobonds. U.S. Treasury bonds are traded around the world, and increasingly U.K. government securities are internationally traded and held.

Trading in equity stocks is also very heavy, but is not yet carried out on any "24-hour trading system". Mention has already been made of the official listing of non-domestic stocks in London, and there is trading on the Exchange of stocks listed on overseas Exchanges. The result can be said to be, at least as far as the London and New York markets are concerned, and as far as concerns a number of leading U.S. and U.K. equities, that there is sequential trading in the two markets. Some trading in U.S. stocks does take place in London in the London trading day. Then there are at any given time some fifty or more leading U.K. stocks in which an active investment interest exists in the U.S. These stocks may be traded, according to whether or not they are listed on the New York Stock Exchange, either there or on the NASDAQ market. There are periods when the trading in the U.S. in some U.K. stocks is significantly heavier than in the U.K. market, as shown by the table at Annex A. At least some of this trading in U.K. stocks outside the home market may be attributed to the fact that the purchase of stocks on the U.K. market attracts an ad valoram stamp duty of 1%, whereas the same stocks change hands free of any stamp duty, in the form of American

Depositary Receipts, on the Wall Street markets. Strong representations have been made to the U.K. Treasury about the uncompetitive position of the London market caused by the stamp duty, and it is to be hoped that it will in time be either reduced or removed altogether.

The London Stock Exchange is also taking active measures to promote a regulated and visible market in non-U.K. stocks in London. A pilot initiative, under the same SEAQ International, has been started, making an early use of the technology which will be used to support the U.K. domestic market following the 'big bang'. If this initiative prospers, it may be expected that in due course a 'tape' of transactions in international securities will be published, which, taken together with the tape in the U.S. will begin to constitute what might be called an international trading system.

The Committee have also asked for information about links between stock exchanges.

Efficient stock markets have always been characterised by the harnessing of the latest available communications technology. Telephones and telex made the operation of markets more efficient a century ago. In our own day electronic communications are being brought dramatically to bear upon the workings of securities markets. It is often said that stock exchange markets, traditionally organised, are no longer necessary. Electronic networks serving thousands of interactive terminals are sufficient for the operation of a transparent market. That is how the market in foreign currencies works, and that is (more or less) how the Eurobond market in London is being encouraged by the S.T.B. to organise itself. Indeed, once the U.K. Stock Exchange has gone past the 'big bang', it will be capable of functioning without the use of the physical trading floor.

Stock markets are not however merely mechanisms for the performance of transactions. If they were to develop along the lines of the foreign exchange markets, based on international communications networks and with little or no regulation, they would similarly be the province of the large professional investor. At present Stock Exchanges play a vital role in the proper regulation of investment business. The U.K. Stock Exchange has been in practice the sole guardian of regulatory responsibility in its own jurisdiction. The prospect of stock markets being translated substantially to international electronic networks carries with it the possibility of a reduction, even a major reduction, in the quality of regulation able to be applied to the markets. The S.E.C. has clearly signalled this danger in a recent concept release.

There is therefore good reason for leading stock exchanges to co-operate in the regulation of business, and to form links to make that co-operation more effective, and to make the markets more efficient. It is on public record that the New York and London Stock Exchanges have set up a task force to study and make recommendations about how such a link could be achieved. A successful link of two of the three largest exchanges in the world would offer the prospect of enhanced regulation and efficiency of markets.

A number of other links are under consideration between the U.K. Stock Exchange and overseas stock exchanges and securities markets. It is proposed that there should be an agreement with the National Association of Securities Dealers here in Washington, whereunder prices of several hundred leading securities from each market would be displayed on the networks of the other. (The Stock Exchange has its own network, serving some 6,000 terminals, almost entirely in the U.K.) A proposal is under active consideration to link the U.K. Stock Exchange with the Philadelphia Stock Exchange, for the trading of a fungible currency option. These links if consummated will assist the efficient operation of the securities markets.

The stock exchanges in the member states of the European Community are co-operating in the laying down of a network which will link all the exchanges, enabling price information, and in time trading and settlement data to be passed between the exchanges. This network is known by the code name I.D.I.S. (Inter-Bourse Data Information System).

Just as important to the functioning of the markets internationally is the availability of clearing and settlement services. The Stock Exchange has a nationwide settlement service in the U.K., code-named Talisman. That service has recently been extended so that Australian securities (in many of which there is active trading in the U.K.) can be settled by book-entry transfer in London. The Talisman system also has links with France, Germany and South Africa, and work is proceeding on plans to form links with the principal clearing corporations in the United States and Canada. The strategy we are adopting, as will be evident, is to make bilateral links with other exchanges and clearing corporations, rather than by attempting to organise an "international clearing system", as a question put by the Committee has it.

It is our confident belief at the London Stock Exchange that the financial markets of the City of London, including The Stock Exchange itself, are well placed to take advantage of the growth in the international trading of securities. The Stock Exchange and its members will have improved their ability to compete with markets overseas, as a result of the changes to its membership structure and dealing systems, described in this note. The Stock Exchange also draws much strength from the fact that it operates and controls its own information and clearing and settlement networks. The existence of a sound regulatory framework for investment business which will follow the enactment of the Financial Services Bill will further strengthen the position of the City of London and increase its attractiveness as an international financial centre.

The **Chairman**. Gentlemen, thank you very much.

I am certainly happy to find out that you have some standards. After listening to the first panel, we might have gotten the impression that it was totally and completely unregulated. I would like you to know that I am aware that you do have standards, although I think it is fair to say that, relatively speaking, we have tighter regulation in certain areas. For example, because of the Glass-Steagall Act we have maintained a separation between banks and securities firms, while you have established an entirely different regulatory structure that permits their integration. This gives you a great deal more flexibility and competitive advantage in this area.

FINANCIAL SERVICES BILL

It is my understanding that the financial services bill that is currently being considered by Parliament includes several provisions that would affect the ability of some non-United Kingdom firms to participate in the London market by applying reciprocity standards. Is that true?

Sir **Martin Jacomb**. Yes, Senator, the provision is in the bill to enable the Government to operate nonreciprocity standards. It's only an enabling provision in the bill, and as I said, I believe the significant case in view is the Japanese case. I don't think there is any suggestion in the case of the U.S. firms, whether they be banks or they be investment banks operating in London, I don't believe there is any suggestion that there will be any nonreciprocity there.

And indeed, the Government would—the authorities in England would be very reluctant to apply nonreciprocity stipulations, because they really believe that the future of London depends on having everybody there. It just is that the issue of reciprocity is very important in the case of the Japanese, because with the huge trade surpluses and the vast amount of capital they have to invest abroad, it is absolutely certain that Tokyo will, as far as the eye can see, be a hugely important financial center.

It is very, very important for British banks to be able to operate in Tokyo on as level terms as possible with the Japanese there. It is not a level playing field by any means, and we just have to do whatever we can to try and ensure that it is made as level as possible.

Mr. **Villiers**. May I add to that, Mr. Chairman?

The **Chairman**. Yes, certainly.

Mr. **Villiers**. I agree with what Sir Martin has said, but I think it is significant that this is the first time a clause of that nature has been introduced into a bill, and although I agree with him that the Government would be extremely reluctant to make use of it, there is a feeling among quite a number of participants in the financial services bill discussions that perhaps some sort of reciprocity standards should be applied. We are talking about a marketplace in London in which everybody can join, and yet the major British institutions are not able to operate on the same level playing field elsewhere.

I think it is true that this has been discussed within the Bank of England and it has also, been discussed, I think, in terms of stock exchange reciprocity. So there is very much a debate going on at the moment which is new to London.

Sir **Martin Jacomb**. I might, Senator, that we would love to be able to play on a level playing field right here in the United States. The difference between a merchant bank or any bank which does not come—let us say, any British bank, which does not under the banking side of the Glass-Steagall Act, the difference between what it is able to do in the United States and what a bank like the one that I now work for and Mr. Villiers now works for, can do, is enormous. And it is not without interest, I think, that when the Midland Bank made its press announcement about the sale of the Crocker Bank in the State of California, at the end of that press release, there is a statement from which you can clearly draw the inference that they have made a decision, or at any rate got themselves into a position to make the decision to switch from the banking to the securities side of the Glass-Steagall Act.

So that there is a very strong feeling, as Mr. Villiers has said, that it is a great disadvantage to us not to be able to operate on a level playing field in the United States with the investment banks here and with the British banks who do not come under the banking side of the Glass-Steagall Act here.

I wonder if—on a different subject, I wonder if I could just add something about what Mr. Knight was saying? I think he is absolutely right to say that it would be wrong for you and your committee to concentrate too much on the need to accelerate the process toward harmonizing regulatory standards. That is an incredibly difficult subject and not one which is likely to be fast, and it is doubtful whether it is really worth a great deal of your energy, because in the end, this process will be demand-driven, and what is really demand-driven is the harmonization between the stock exchanges. It is the stock exchange in London and the exchanges here in the United States wanting to get each other's business. So there is a perfectly powerful business drive toward harmonization, and I doubt—with all the rest of what you have to concentrate on, I doubt whether that is a terrifically useful destination for energy.

STANDARDIZED ACCOUNTING STANDARDS

In regard to accounting standards, I think it is extremely unlikely that standardized accounting standards are reachable in the near future. The standards here in the United States are extremely strict. Anybody who wants to come to the U.S. market can comply with them. That is what we did in the case of British Telecom, an issue which Mr. Knight referred to, with which I was closely involved. We made that issue, which was the biggest equity issue ever anywhere in the world, and we wanted to tap the markets here; so we complied with the standards and came here. But the requirements here, with particularly the frequency with which people have to report profits and the frequency with which they have to report profits on a segmented basis, is contrary to what the modern flow of opinion or, anyway, the flow of opinion which is just beginning in London, is; there is a feeling in London growing, that investors pay far too much attention to very short-term trends, which leads to short-term fluctuations, which makes it harder for genuine industrialists to take longer term views.

Bearing in mind that industrial investment decisions have lead times of sometimes a decade and sometimes more, it is a tough thing for them to have to deal with quarterly reporting on a segmented basis, just for the satisfaction of investors who want to watch the price of the stock on a daily basis.

So that I think the pursuance of standardized worldwide accounting standards is going to be difficult, but I think none of us object to the very high standards that you have here in the United States. We are perfectly ready to see that if we want to come and use these capital markets, we've got to comply with them, that is the higher standards which apply here.

The real point is, I think, that we can achieve the real purpose, which is protecting investors and protecting depositors, without harmonized standards, but with the right standard of regulation which provides a level playing field in each center.

The CHAIRMAN. You should not worry too much about our leading the way even when you speak of demand-driven charge. We have a hard time moving the Congress of the United States in response to our own domestic financial markets, despite the revolutionary charges in these markets. I have been pushing and shoving for the last 5 years but I have been unable to get the House of Representatives to do anything. So don't concern yourself with our suddenly rushing in and negotiating common standards. The market will have to drive a lot harder before we can do that. We also have problems with reciprocity and level playing fields in our retail banking operations in many countries around the world forgetting the securities end of it that you have been discussing.

I have been to Australia, Korea, and other countries and have threatened them with national treatment and reciprocity if they don't open up their markets. Of course, Australia has thrown us a few crumbs with the Martin and Campbell reports, but not much more than crumbs. That is essentially true in many other countries as well.

So I may have to get much more serious about a new national treatment bill. Rather than just putting it out there to get their attention, I may have to push that a little harder, at least in the area of retail banking.

Gentlemen, I have a lot of additional questions for you, but we have run on at considerable length, and we are going to have a roll call vote on the floor shortly, so I would appreciate it if you would be kind enough to respond to some additional questions in writing for the committee.

The CHAIRMAN. I appreciate very much your willingness to be here and your background and experience in this area, and we will be calling on you for some additional information.

Thank you very much.

The committee is adjourned.

[Whereupon, at 12:28 pm., the hearing was adjourned.]

[Response to written questions of Senator Garn, Heinz, and Riegle follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM DENNIS WEATHERSTONE

Q.1. Please describe in detail the role that commercial banks have played in the Euromarkets. How has this differed from their role in the U.S. markets?

In addition to deposit-taking and lending activities in the Euromarket, U.S. commercial banks, as permitted under the Edge Act, have engaged through affiliates in underwriting and dealing in corporate securities. Their role in this market is substantial: of the top 30 managers of Eurobond issues in 1985, five were U.S. commercial bank subsidiaries. Morgan Guaranty Ltd., a subsidiary of Morgan Guaranty Trust Company of New York, ranked third in 1985 behind Credit Suisse First Boston and Merrill Lynch Capital Markets. According to a 1985 Euromoney poll, 3 of the 10 most innovative underwriters were U.S. bank affiliates.

The activities of bank underwriting affiliates in the Eurobond market are virtually indistinguishable from those of traditional investment banking firms. As such, U.S. banking organizations are able in the Euromarket to offer their customers the full range of products and services that foreign bank competitors can provide. In the U.S. market, on the other hand, commercial banks and their affiliates are generally precluded from underwriting and dealing in corporate securities, while sixteen of their foreign bank competitors are allowed to engage in those activities as a result of being "grandfathered" by the International Banking Act of 1978. As discussed further below, the favorable treatment accorded to these foreign banks puts U.S. banks and securities firms at a competitive disadvantage in both foreign and domestic markets.

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GARN--WEATHERSTONE

Q.2. According to the testimony, commercial banks have played an important competitive role in underwriting and trading securities in the Euromarkets. Based on this performance, what competitive role would they be likely to play in the U.S. market if they were permitted to engage in securities activities here? Are there any reasons why banking organizations would not be as successful in underwriting and dealing in corporate securities in the U.S. markets as they have been in the Euromarkets?

U.S. commercial bank affiliates would bring new and much needed competition to U.S. capital markets if they were permitted to engage domestically in corporate securities activities. Numerous studies have shown that the Euromarkets, in which commercial bank affiliates actively compete with securities firms, are significantly less concentrated than the securities markets in the United States. For example, in 1985, the top 4 "bookrunning" underwriters had a 27% market share in the Eurobond corporate debt market compared to a 65% market share for the top 4 "bookrunning" underwriters in the U.S. corporate debt market. Similarly, the market for municipal general obligation bonds in which U.S. banks can compete is significantly less concentrated than the market for those municipal revenue bonds from which they are excluded.

There is no reason why banking organizations would be less successful in underwriting and dealing in the U.S. than in the Euromarkets. Moreover, there is a good reason why they might be more successful. The fact that banking organizations cannot fully serve their customers' financing needs on a world-wide basis--because of restrictions in the U.S.--diminishes their ability to attract customers in the markets they can serve. Thus, if commercial bank affiliates were permitted to underwrite and deal in corporate securities in the U.S., their ability to compete in all markets would be enhanced.

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GARN--WEATHERSTONE

Q.3. Does the relationship between Credit Suisse and First Boston (or other similar combinations) give such institutions an advantage in the Euromarkets? In the U.S. domestic market? In other markets? If so, are other institutions likely to make similar combinations? Why or why not?

The affiliation of Credit Suisse and First Boston enables the combined organization to offer investment and commercial banking services in both the Euromarket and the United States. As indicated in the response to Question #1, numerous other foreign bank competitors, including Deutsche Bank, Swiss Bank Corporation and Union Bank of Switzerland, are able to engage in both activities in these key markets as a result of being "grandfathered" by the International Banking Act of 1978. Until U.S. laws are changed, however, only these grandfathered organizations will be able to engage in commercial and investment banking activities in the United States, to the competitive disadvantage of both U.S. banking and securities firms.

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GARN--WEATHERSTONE

Q.4. It has been suggested that the Euromarkets are largely "unregulated," yet testimony at the hearings indicated that, in fact, certain types of regulation do apply. Please describe how the Euromarkets are regulated. Are Euromarket issues ever listed on exchanges, and if so, do they become subject to the regulations of either these exchanges or of the countries in which the exchanges are located? Please describe the regulatory requirements that are imposed at each stage of Euromarket underwriting and trading, and how these requirements are different from those applying to domestic bond issues.

It is certainly correct that the Euromarkets are not totally unregulated. The firms which underwrite and trade Euromarket securities, many of which are based in London, are generally subject to some form of regulation in the country or countries in which they have offices. Many London-based firms, including some affiliated with American banks, are British merchant banks and as such are subject to supervision and regulation by the Bank of England under the British Banking Act of 1979. Moreover, the offer and sale of securities in Great Britain and the distribution of offering materials in or from Great Britain are subject to the provisions of the Companies Act and the Prevention of Fraud (Investments) Act. Finally, affiliates of U.S. banks are subject to supervision by U.S. banking authorities.

Eurodollar issues are almost always listed on a stock exchange, usually London or Luxembourg. Both exchanges have requirements as to the contents of the prospectus or other offering document concerning each new issue, and both exchanges require issuers to make available certain financial information on a continuing basis. Where United States issuers are involved, the degree of disclosure in connection with a new issue is not substantially different than that which prevails in this country.

Although virtually all Euromarket debt issues (other than short-term issues) are listed on a stock exchange, most of the trading takes place through dealers rather than on the floor of an exchange. The dealers are linked to each other by telephone and are located in various countries, but London remains the largest single dealing center.

Although the trading market has to date been largely unregulated, the Financial Services Bill now before the British Parliament will substantially increase the extent to which the London-based segment of the market is regulated. So far as international securities are concerned, the bulk of the regulation is expected to be handled by a self-regulatory organization to be set up under the aegis of a new Securities and Investment Board, which in turn will be subject to oversight by the Department of Trade and Industry.

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GARN--WEATHERSTONE

Q.5. Does the internationalization of capital markets make it more difficult for the United States and other countries to control their monetary policies? If so, what suggestions have been made or actions taken to address this problem?

The internationalization of capital markets has not led to any dramatic loss of control over monetary policy. Instead, this change has caused the monetary policies of different countries to become more interdependent. With internationalization, economic events and policies in one country are more quickly and decisively transmitted to other countries. For example, if one country follows a monetary policy that is considered by the marketplace to be expansive compared to the monetary policies being pursued in other countries, downward pressures on the value of that country's currency would soon develop. This would lead to an improvement in its trade balance, which means, of course, that other countries' trade positions would be made worse. Internationalization has also helped change the relationship between the monetary aggregates and GNP because foreign holders of dollar-denominated financial assets have different portfolio preferences than domestic residents. As a result, internationalization has created some short-run uncertainty about what monetary aggregate targets are appropriate.

Overall, despite these minor difficulties, internationalization should be viewed with favor. It facilitates an efficient allocation of resources. Although U.S. government borrowing clearly needs to be reduced, internationalization has mitigated the consequences of the recent large budget deficits.

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GARN--WEATHERSTONE

Q.6. At a time when U.S. firms are not allowed to be primary dealers in Japan, what is your view about the application of Japanese firms to be primary dealers in the United States?

In our open, competitive government securities market, we favor allowing any firm to become a primary dealer that has the requisite capital, expertise and commitment to the market. We strongly hope that other financial markets, such as Japan, will adopt this policy as well.

Q.7. Have international capital markets grown in London at the expense of New York? If so, is this trend likely to continue?

London has grown more rapidly than New York as a center for corporate bond financing. Much of this growth can be attributed to the rapid growth of the Eurobond market, which has grown far faster than the corresponding U.S. corporate debt market.

Recent developments suggest that this trend will continue. Leading investment and commercial banking organizations are adding to their staffs in London to accommodate further growth in the Eurobond market. In addition, these firms are expanding to prepare for further deregulation of the London securities market.

The growth of London as a financial center is not occurring by accident. The market is undergoing significant deregulation (e.g., the end of the legal separation of the jobber, underwriter and broker) precisely to make the market more efficient and to ensure that London will continue to be one of the world's major financial centers.

PERCENTAGE TURNOVER IN ADR FORM OF MAJOR UK EQUITIES

1985	Jan	Feb	Mar	Apr	May	Jun	July	Aug	Sept	Average of 9 months
BP	8.5	16.2	26.9	42.3	28.0	35.0	19.9	13.6	14.2	22.7
BT	27.0	19.2	15.8	7.6	20.0	6.0	8.6	9.6	11.7	13.9
ICI	55.6	54.9	48.9	53.0	63.0	54.0	45.2	66.2	56.7	55.3
Plessey	1.2	4.0	2.3	1.3	0.0	1.0	0.1	0.9	1.3	1.3
Shell	47.0	52.2	52.6	62.4	58.0	65.0	49.8	48.8	40.7	52.9
Tricentrol	2.3	1.0	2.2	3.8	3.0	6.0	1.9	2.0	0.8	2.6
Cadbury	56.6	58.6	66.8	52.5	45.0	67.0	58.3	51.9	57.8	57.2
Reuters	33.4	40.4	36.3	27.0	23.0	46.0	40.4	34.7	15.4	33.0
Saachi	28.3	28.7	7.2	22.8	13.0	9.0	5.1	6.2	4.9	13.9
Beecham	3.6	5.6	29.0	5.4	6.0	8.0	13.3	15.3	19.9	11.8
Bowater	9.5	13.9	27.1	20.0	1.0	5.0	19.9	23.1	2.5	13.6
Burmah	1.5	4.0	5.1	2.7	9.0	5.0	10.1	5.5	1.7	5.0
Fisons	25.4	22.9	16.2	38.0	23.0	33.0	25.5	23.8	19.3	25.2
Glaxo	55.1	69.6	65.6	61.3	65.0	68.0	61.0	69.0	61.1	64.0
Rank	10.7	5.1	7.2	13.6	18.0	8.0	11.1	16.5	21.8	12.4

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GARN--WEATHERSTONE

Q.8. Given the differences in regulation between the U.S. markets and the Euromarkets, have there been any significant differences in the number of failures or near failures of financial institutions?

Despite the differences in regulation between the two markets, both U.S. and foreign banking organizations have successfully pursued securities activities in the Eurobond market. Past experience has shown that the differences in regulation have not led to a greater incidence of financial difficulty on the part of firms active in the Eurobond market. In general, there have been relatively few failures of significant size in either market.

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GARN--WEATHERSTONE

Follow-Up Questions for Feb. 26 Hearing on the Internationalization of Capital Markets

Q.1. Looking at the historical safety of the Euromarkets, does it make sense generally to have different regulatory procedures for transactions among sophisticated institutions as opposed to transactions involving individuals and smaller institutions?

Different regulatory procedures are appropriate depending on the sophistication of investors, and this is recognized by the Securities Act of 1933, particularly its provisions permitting sales of securities without registration in private placements to sophisticated investors. The laws of many other countries recognize somewhat similar distinctions. Certainly investors who can "fend for themselves" are on a different footing from others, but, as already noted, the Euromarkets are not totally "unregulated", and we do not suggest that even purely institutional markets should be totally free from regulation.

Q.2. Do you support the eventual development of a common regulatory or disclosure system for participants in international capital markets?

We doubt that in the foreseeable future it will be practicable to develop a completely uniform regulatory or disclosure system for the major industrialized countries, and therefore we believe that "harmonization" rather than uniformity represents a more realistic goal over the next few years.

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GARN--WEATHERSTONE

Q.3. How would you recommend changing the U.S. regulatory structure to increase our competitive position in world markets without threatening the safety and integrity of the financial system?

Congress should revise the U.S. regulatory structure to permit commercial banks to have affiliates that underwrite and deal in corporate debt and equity securities and, conversely, to permit securities firms to affiliate with commercial banks--in each case through a holding company structure. This would allow American financial organizations to offer the same broad range of products and services as many of their foreign competitors, thus enabling them to compete more effectively in world markets.

Allowing the linkage of commercial banking and securities activities in this manner would enhance the safety and integrity of our financial system. Financial organizations in the U.S. would be better equipped to meet their customers' needs. In addition, they would be less apt to encounter financial difficulty because the resulting diversification of their sources of income would reduce their vulnerability to adverse developments in any particular segment of their business.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM DENNIS WEATHERSTONE

Q.1. In a number of the prepared statements submitted for this hearing, the point is made that currency volatility has led bankers and financial officers to find new financial instruments and techniques to hedge against that volatility. It could also be agreed that the very size of cross-border transactions, including hedging and currency swap transactions, increases the prospects for currency volatility. What do you see as the determinants of exchange rate volatility? It is likely to be a frequent feature of a growing international capital market? Is a stable, low inflation, macroeconomic policy environment in the major Western economies the prescription for exchange rate stability?

A. Q.1. The large and growing volume of cross-border financial transactions is not the cause of exchange rate volatility. Exchange rate instability primarily reflects actual and expected changes and/or divergence in the economic performance and policies of the major industrial countries, and is not an inevitable feature of international capital markets. A stable, low-inflation economic policy environment in the major Western economies would go a long way toward ensuring greater exchange rate stability.

Q.2. Last September, the G-5 governments met in New York and agreed on a more active policy of coordinated intervention to ensure that their currencies accurately reflected the underlying strengths of their economies and to combat speculative currency movements. Since that time, the dollar has fallen roughly 15 percent against the deutschemark and yen. Does this reflect the success of the intervention agreement or other factors? Can intervention affect the market on more than a short-term basis -- actually changing underlying currency values?

Several pieces of legislation pending before the Congress call for accumulation of reserves of foreign currency to be used in a more active U.S. intervention policy. Would this be a useful step, in your view?

A. Q.2. While the G-5 agreement to undertake coordinated exchange market intervention undoubtedly contributed to the dollar's decline since last September, the success of intervention per se depended on a rather special combination of circumstances and is not evidence that intervention alone can produce a lasting change in underlying currency values. Last September there was widespread agreement among the G-5 governments and market participants that the dollar was still significantly overvalued, even though the dollar already had fallen considerably from its peak levels earlier in that year. The combination of prospective fiscal deficit reduction, declining U.S. interest rates, and frequent expression of views by U.S. officials on the role of exchange rate changes in correcting unacceptably large trade imbalances, contributed to the dollar's decline. Exchange market intervention can be useful in maintaining orderly market conditions and occasionally in nudging exchange rates in a certain direction, but its effects are short-lived if not reinforced by changes in underlying policies.

The accumulation of foreign currency reserves might enhance market perceptions of the credibility of a U.S. commitment to a more active intervention policy. However, to the extent the U.S. objective is to encourage a lower dollar exchange rate, there is no need for prior accumulation of foreign currency reserves. Moreover, the existence of large Federal Reserve swap lines with other central banks, through which the Federal Reserve can obtain foreign exchange, lessens the need for holding large foreign currency reserves.

Q.3. The Administration talks increasingly about the idea of reform of the world monetary system, as most recently indicated in the President's State of the Union address. Presumably the goal would be greater management and stability of currencies. Do you see a need for fundamental reform of the system and what changes, if any, are needed? What benefits or problems would arise from such a change?

A. Q.3. The G-5 agreement last September and subsequent agreements in the G-10, Interim Committee, and recently at the Tokyo Summit, represent steps toward greater policy coordination among the major industrial countries and, as such, can be viewed as adding up to the first stage of evolutionary reform of the world monetary system. Avoidance of major exchange rate misalignment and reduction of short-term exchange rate volatility require that major industrial countries set consistent economic objectives and coordinate economic policies to achieve these objectives. As is evident from the cautious reactions to U.S. proposals outlined at the Tokyo Summit, agreement on mutually consistent objectives and implementation of coordinated policies raise familiar and difficult issues of reconciling divergent national aims and of accommodating national sovereignty concerns to broader international interests. However, failure to make progress along these lines could unleash more protectionism and lead to poor economic growth in the industrial world.

Q.4. Concerns have been expressed that the massive current account and fiscal deficits of the U.S. vis a vis the rest of the world could lead to a loss of confidence in the U.S. economy, resulting in a rapid drop in the value of the dollar and in capital inflows. Actual experience over the last year has been of gradual decline in the exchange rate and modest inflation. With the dollar declining but with uncertain prospects for fiscal deficit reductions, what do you see as the prospect for foreign capital inflows to the U.S.?

A.Q.4. By definition, as long as the U.S. runs current account deficits, it will have net capital inflows. The question is at what interest and exchange rates these net inflows occur. As long as market participants, both foreign and domestic, perceive that the Federal Reserve is pursuing prudent monetary policy and that the Administration and Congress are moving effectively to reduce federal budget deficits in the years ahead, sizable net foreign capital inflows should continue without undesirable interest or exchange rate consequences. Moreover, the dollar's decline, especially if combined with stronger economic growth abroad, should help bring about an eventual narrowing of U.S. trade and current account deficits, and thereby lessen U.S. dependence on foreign capital inflows.

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HEINZ--WEATHERSTONE

Q.5. Financial transactions have grown to be many times larger than underlying commercial transactions -- one estimate places financial transactions at 12 times world trade. What are the principal determinants of these massive financial flows? How do these flows relate to underlying trade transactions? The free flow of capital is normally viewed as beneficial, but are there ways in which it is a destabilizing influence?

A.5. Most of these financial transactions are undertaken to settle financial market activity, such as foreign exchange trades or securities transactions. The growth of such trading activity results in more liquid and efficient financial markets and facilitates world trade by ensuring that both borrowers and lenders can limit their foreign exchange exposures.

The basic economic forces that determine the trade balances among nations and the resulting offsetting capital flows typically work quite slowly. Thus, capital flows generally have a stabilizing influence in the longer term. For example, the large U.S. trade deficit has resulted in dollars being accumulated abroad. Those dollars have then flowed back into the United States as foreigners have invested in U.S. financial assets. This capital inflow has helped to finance the U.S. budget deficit.

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HEINZ--WEATHERSTONE

Q.6. Major LDC debtors have experienced serious difficulty meeting external payments due to adverse external developments (falling commodity prices, higher interest rates) and flawed domestic economic policies. The Baker initiative announced in Seoul calls for market oriented policy reforms to promote private sector growth supported by additional commercial and official lending. What do you see as necessary to restore the confidence of financial markets in the key debtors? What are their prospects for attracting investment or raising capital in international markets for the forseeable future?

A.6. For the financial markets to regain confidence, LDC debtors need to pursue macroeconomic policies that result in realistic interest and foreign exchange rates and that promote price stability. In addition, these nations need to:

1. Undertake basic structural reforms to reduce the role of the government in economic activity;
2. Improve the climate for both domestic and foreign investment; and,
3. Encourage further expansion and diversification of the export sector.

If such changes are made and consistently pursued, these countries will eventually regain the ability to raise funds through voluntary lending. Realistically, this will occur sooner for some countries than for others since circumstances differ considerably from debtor to debtor.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM DENNIS WEATHERSTONE

Q1. What do you think should be the role, if any, of the Securities and Exchange Commission and the government in attempting to harmonize standards of securities regulation worldwide and in attempting to facilitate international settlement facilities, international consolidated reporting, consolidated quotations, and intermarket linkages?

We believe that the Securities and Exchange Commission and other governmental organizations should be working actively with their foreign counterparts to facilitate international securities transactions through harmonizing the applicable securities regulations of the major industrialized countries. The SEC has already taken some important steps in this area, but more will need to be done. In our view, substantial harmonization can be accomplished without any sacrifice in terms of the protection of American investors, but flexibility and imaginativeness will be required, and in some cases Congress will have a role to play because statutory changes may be needed.

As for international settlement facilities, international consolidated reporting and quotations, and intermarket linkages, we would expect private initiatives to play the major role, but the regulators in various countries will have to see to it that local regulations do not impede sensible forward steps.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM ROBERT D. HORMATS

Q.1. According to the testimony, commercial banks have played an important competitive role in underwriting and trading securities in the Euromarkets. Based on this performance, what competitive role would they be likely to play in the U.S. market if they were permitted to engage in securities activities here? Are there any reasons why banking organizations would not be as successful in underwriting and dealing in corporate securities in the U.S. markets as they have been in the Euromarkets?

A. 1. It is difficult for me to say what role commercial bankers would like to play in the U.S. market although I am sure that commercial bankers themselves will cover this thoroughly. I would simply state that, as the Glass Steagall Act implies, the underwriting of securities and commercial banking are two different functions. In considering whether to modify the law which segments these two industries, the Committee should consider carefully the nature of the underwriting business. It is highly risk oriented. The underwriter must put up large sums of money, often with only a few hours notice. And that money is at risk in the transaction. The funds themselves belong to the partnership or the stockholders of the underwriting firm. There is no government guarantee. Commercial banks, on the other hand, are using the money of their depositors, and a portion of their deposits benefit from a government guarantee. Those funds which would be put at risk in a commercial bank underwriting would, in effect, be depositors funds and indeed ultimately the Federal government would be liable should a number of those risk go sour.

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GARN--HORMATS

Q.2. Does the relationship between Credit Suisse and First Boston (or other similar combinations) give such institutions an advantage in the Euromarkets? In the U.S. domestic market? In other makrets? If so, are other institutions likely to make similar combinations? Why or why not?

A. 2. Certainly the relationship between an investment bank and a commercial bank, or a "universal bank" has an advantage in Euromarkets. Many of these underwrite issues, and then, if the issues do not sell out, they can put the unsold shares or bonds on their books. Also many of them have discretionary accounts into which they can sell shares or bonds that are not sold in capital markets. There are likely to be more combinations of this sort, or instances in which a large corporation with a major capital portfolio buys an investment bank. That also gives the investment bank more latitude to place unsold shares internally.

Q. 3. Does the internationalization of capital markets make it more difficult for the United States and other countries to control their monetary policies? If so, what suggestions have been made or actions taken to address this problem?

A. 3. Surely the internationalization of capital markets does make it more difficult for the U.S. and other nations to control their monetary policy. It increases the possibilities for large volumes of capital to move quickly across borders. Short of capital controls which are highly discretionary, the only way this problem can be dealt with is for there to be greater harmony among the monetary and fiscal policies of major economies.

Q.4. At a time when U.S. firms are not allowed to be primary dealers in Japan, what is your view about the application of Japanese firms to be primary dealers in the United States?

A. 4. A number of U.S. securities firms have indicated their hope that American firms will be given treatment in Japan similar to that given Japanese firms in the U.S.

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GARN--HORMATS

Q.5. Have international capital markets grown in London at the expense of New York? If so, is this trend likely to continue?

A. 5. The London market has grown substantially, doubtlessly taking some business from New York. This trend is likely to continue so long as there is a major difference between regulation here and in London. Issuers tend to go where markets are less regulated.

Q.6. Given the differences in regulation between the U.S. markets and the Euromarkets, have there been any significant differences in the number of failures or near failures of financial institutions?

A. 6. To my knowledge, there have been no significant differences in the number of failures or near-failures of financial institutions.

Q.7. What additional precautions, if any, must a manager of a U.S. pension fund take if investments overseas are to be as safe as investments in the United States?

A. 7. Pension fund managers generally want as much information about an overseas investment as about an investment in the U.S. Traditionally investment managers will do an analysis of the country in which they are investing abroad in addition to an analysis of the company in question.

Q.8. Does the internationalization of capital markets increase the potential for massive capital flows into or out of a currency? Does this increase the likelihood that exchange creates will not move to reduce current account surpluses?

A. 8. The internationalization of capital markets does increase the potential for large capital flows. Because capital moves on the basis of returns, it is not so sensitive in the near term to current account issues. Thus, unlike in the past, a country with a large trade deficit may see its currency strengthen because the returns on capital are attractive.

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GARN--HORMATS

Follow-Up Questions for Feb. 26 Hearing on the Internationalization of Capital Markets

Q.1. Looking at the historical safety of the Euromarkets, does it make sense generally to have different regulatory procedures for transactions among sophisticated institutions as opposed to transactions involving individuals and smaller institutions?

A. 1. There is good reason for having different regulatory procedures for transactions among sophisticated institutions relative to those involving individuals and small institutions. Although over a period of time those regulations relating to individuals and small institutions should move closer to those for sophisticated institutions.

Q.2. Do you support the eventual development of a common regulatory or disclosure system for participants in international capital markets?

A. 2. A common, or at least a similar, regulatory or disclosure systems among the major countries would be desirable.

Q.3. How would you recommend changing the U.S. regulatory structure to increase our competitive position in world markets without threatening the safety and integrity of the financial system?

A. 3. Steps could include less frequent report requirements, less S.E.C. paperwork, and more latitude for the use of private placements.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM ROBERT D. HORMATS

Q.1. In a number of the prepared statements submitted for this hearing, the point is made that currency volatility has led bankers and financial officers to find new financial instruments and techniques to hedge against that volatility. It could also be agreed that the very size of cross-border transactions, including hedging and currency swap transactions, increases the prospects for currency volatility. What do you see as the determinants of exchange rate volatility? It is likely to be a frequent feature of a growing international capital market? Is a stable, low inflation, macroeconomic policy environment in the major Western economies the prescription for exchange rate stability?

A. 1. Currency volatility is caused by changing expectations about interest rates, growth rates, political stability, etc. So long as expectations change and national policies and performance change frequently there is a high prospect of exchange rate volatility. A relatively stable macro economic environment should help stabilize currency rates, although we should recognize that currency rates over the past year have been quite volatile even though inflation rates have converged downward.

Q.2. Last September, the G-5 governments met in New York and agreed on a more active policy of coordinated intervention to ensure that their currencies accurately reflected the underlying strengths of their economies and to combat speculative currency movements. Since that time, the dollar has fallen roughly 15 percent against the deutschemark and yen. Does this reflect the success of the intervention agreement or other factors? Can intervention affect the market on more than a short-term basis -- actually changing underlying currency values?

Several pieces of legislation pending before the Congress call for accumulation of reserves of foreign currency to be used in a more active U.S. intervention policy. Would this be a useful step, in your view?

A. 2. The decline of the dollar is less the result of intervention and more the result of the market selling off an overvalued dollar and of less attractive U.S. interest rates. Intervention can be helpful in the short term but not in changing underlying currency values over a substantial period of time. Accumulating more reserves for the purposes of intervention would be a useful step but not one that can be relied on to have a fundamental long term impact on exchange rates.

Q.3. The Administration talks increasingly about the idea of reform of the world monetary system, as most recently indicated in the President's State of the Union address. Presumably the goal would be greater management and stability of currencies. Do you see a need for fundamental reform of the system and what changes, if any, are needed? What benefits or problems would arise from such a change?

A. 3. At this point it is too early to decide what type of reforms of the system are desirable or necessary. Less important than reform of the exchange rate system per se is the establishment of an improved framework for the management of domestic policies to avoid current account imbalance. That would in turn likely smooth out currency movements.

Q.4. Concerns have been expressed that the massive current account and fiscal deficits of the U.S. vis a vis the rest of the world could lead to a loss of confidence in the U.S. economy, resulting in a rapid drop in the value of the dollar and in capital inflows. Actual experience over the last year has been of gradual decline in the exchange rate and modest inflation. With the dollar declining but with uncertain prospects for fiscal deficit reductions, what do you see as the prospect for foreign capital inflows to the U.S.?

A. 4. Capital flow into the U.S. has not diminished noticeably as the dollar has declined although there have been periods during the decline when foreigners have held off buying U.S. securities for a time. A major decline in U.S. interest rates coupled with poor inflation outlook could set off capital outflow.

Q.5. Financial transactions have grown to be many times larger than underlying commercial transactions -- one estimate places financial transactions at 12 times world trade. What are the principal determinants of these massive financial flows? How do these flows relate to underlying trade transactions? The free flow of capital is normally viewed as beneficial, but are there ways in which it is a destabilizing influence?

A. 5. Capital flows are determined by several factors including relative rates on capital, political stability, inflationary expectations and exchange rate expectations. In the near term they relate much more to these factors then to trade balances, although a country with a prolonged trade deficit and a large build up of foreign debt would become over a long period a less attractive country in which to invest because of the prospects of a fall in its currency. While capital flows can destabilize currencies, capital controls to prevent such flows could themselves seriously distort trade investment. Indeed, if the U.S. were to have restricted the inflow of capital to try to avoid the appreciation of the dollar in 1982 through 1985, we would simply have had higher interest rates in this country.

Q.6. Major LDC debtors have experienced serious difficulty meeting external payments due to adverse external developments (falling commodity prices, higher interest rates) and flawed domestic economic policies. The Baker initiative announced in Seoul calls for market oriented policy reforms to promote private sector growth supported by additional commercial and official lending. What do you see as necessary to restore the confidence of financial markets in the key debtors? What are their prospects for attracting investment or raising capital in international markets for the forseeable future?

A. 6. The key debtors need to reduce the size of bloated state-owned enterprises, maintain market oriented currency rates, provide more financial support for private sector companies and avoid excessive increases in government deficits and in money supply. So long as domestic economic policies are eratic, capital inflow is not likely to occur nor will the outflow in capital be reversed.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM ROBERT D. HORMATS

Q1. What do you think should be the role, if any, of the Securities and Exchange Commission and the government in attempting to harmonize standards of securities regulation worldwide and in attempting to facilitate international settlement facilities, international consolidated reporting, consolidated quotations, and intermarket linkages?

A.1. It is highly desirable for the S.E.C. to harmonize standards of security regulations worldwide. This helps to protect investors and it avoids issuers shopping around to do their issues in the least regulated market. If we are truly to have a global market then greater harmonization is clearly desirable.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM GORDON S. MACKLIN

Q.1. Looking at the historical safety of the Euromarkets, does it make sense generally to have different regulatory procedures for transactions among sophisticated institutions as opposed to transactions involving individuals and smaller institutions?

Q.2. Do you support the eventual development of a common regulatory or disclosure system for participants in international capital markets?

Q.3. How would you recommend changing the U.S. regulatory structure to increase our competitive position in world markets without threatening the safety and integrity of the financial system?

NASD

National Association of
Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006
(202) 728-8000

Dear Senator Garn:

This letter is in response to your request for certain additional information to complete the record of hearings held before the Committee on February 26, 1986 relative to the internationalization of capital markets. Several questions were posed relating to the role of the Securities and Exchange Commission in the evolution of the international market for securities and the nature of appropriate regulatory standards applicable thereto.

The National Association of Securities Dealers, Inc. ("NASD") has focused considerable attention on the issue of internationalization of the securities markets, both in terms of comment previously submitted to the Commission and its agreement with the London Stock Exchange for the exchange of quotation and trade information. We believe that, consistent with the mandate of Congress embodied in the Securities Exchange Act Amendments of 1975, it is imperative that the Commission proceed in a manner designed to assure that the present strong, effective and efficient capital raising and capital allocating system can be maintained in this country. Internationalization will undoubtedly require that our domestic markets adapt and respond to the competitive pressures from abroad to prevent any adverse impact on the economic, financial or commercial interests of this country or erosion of its leadership position as a world financial center. Equally important will be the maintenance of investor confidence and protection through effective regulation under the current changing economic and technological conditions which characterize these evolving markets. We believe the questions posed to us by the Committee squarely present the issue of how best to assure that both of these fundamental goals are achieved in the near and longer term.

The NASD believes, and has stated to the Commission, that these goals can best be achieved in the near term by encouragement of future cooperative international initiatives designed to facilitate the development of international securities markets through technological and competitive advancements.

We are beginning to see the shape of the world market for equities. Market center-to-market center linkages will share up-to-the-second price and trade information and thus provide the basic data for decentralized trading. Dissemination of this information to the worldwide investor community will be vital to market depth and liquidity. Surveillance and regulation in the market centers will be facilitated by these linkages and information flows. Networks parallel to this structure will link clearing and depository information and inject essential foreign exchange information into the whole system.

Multiple trading locations, multiple clearing and depository locations, multiple currency settlement facilities and multiple cooperating self-regulatory organizations will be the principal building blocks of the world market for equities.

The volume and pattern of international securities dealings which has developed and the experience to date demonstrates considerable benefit and advantage to further maturation of the foreign operations being undertaken in today's marketplaces. There is today substantial foreign demand for domestic securities which is being satisfied by the evolving market structure. Such demand could be easily stifled by foreign reaction to premature or unnecessary American regulatory initiatives.

Significant competitive inducements exist to enhance foreign cooperation and growth in trading opportunities through communications technology, existing international market forces and the innovation potential of the domestic securities market and vendors of securities information in dealing with the international markets.

The NASD believes that restraint should be exercised by the Congress and the Commission in consideration of any proposals for application of formalized market structure elements to the international marketplace at this time. During this evolutionary period of the international marketplace, concentration upon the control of foreign markets and the practices unique to each may tend to restrain rather than enhance international cooperation and development of competitively motivated market interaction.

A more appropriate emphasis would be upon generalized facilitation of trading among international markets and linkages between clearing and settlement systems to provide the experience and economic incentive necessary to foster the expansion of trading opportunities. Additionally, this approach would provide a climate for advocation of cooperative regulatory initiatives which can be accepted in foreign jurisdictions without undue disruption to existing patterns of activity or retributive action by foreign governments or their regulatory bodies.

It would appear advisable during the near term to recognize to the extent possible the law applicable in foreign jurisdictions until changed through cooperative endeavor, thus avoiding the impression that American law and securities market structures are solely appropriate for universal application. Such would undoubtedly have a negative impact on global market evolution.

Recognition should also be given to the fact that regulation is effective and beneficial to investors' interests only where it concurrently accommodates and addresses the activity taking place. The possible regulatory initiatives referenced in the Committee's questions may be premature at this point. For example, information dissemination techniques may evolve through utilization of emerging communications technology far more quickly through private initiative than through politically sensitive attempts to impose domestic concepts of regulation upon world markets. These and other regulatory requirements should be considered only after concrete experience has been gained with expanded international markets and only to the extent that experience justifies such regulatory approaches. Thus, the Commission at the outset should be considering the needs of the diverse international financial interests which will be represented in the international marketplace. This consideration should include recognition of the regulatory approach of other countries under a scheme of continuing review which may prompt an evolution of foreign markets to the acceptance of certain of our laws, where appropriate.

Also important in this regard, is a careful and objective reappraisal by the Commission of all aspects of domestic securities laws applicable to foreign transactions to assure they do not constitute barriers to the development of an international marketplace. Concurrently, the laws and practices of foreign countries should be reviewed to identify foreign barriers to entry and competition by our markets, and steps initiated seeking removal of such barriers. A specific concern of the NASD is the unequal treatment by certain countries of NASDAQ over-the-counter securities as opposed to listed exchange securities. We believe your Committee's request to the Treasury

Department to conduct a study on foreign government treatment of domestic securities firms and markets constitutes a major step forward in this regard which we heartily endorse. In this regard, we would appreciate your consideration of inclusion of foreign treatment of NASDAQ securities within the scope of the study.

In sum, the NASD believes that the proper approach would be to carefully monitor developments in the international marketplace and to provide for the pooling of information with the Commission to assure the development of appropriate regulatory initiatives should such prove warranted. As these markets develop, regulatory and surveillance programs will necessarily form an integral part of planning by the self-regulatory organizations, which hopefully can be provided for through cooperative undertakings with comparable organizations abroad as part of any planned market linkages. As experience is gained with these linkages, refinements can be made to these regulatory surveillance programs consistent with the perceived need for such by the self-regulatory organizations working in concert with the Commission.

Sincerely,

Gordon S. Macklin
President

QUESTIONS FROM SENATOR GARN TO MR. CALVIN

Question 1.

What additional precautions, if any, must a manager of a U.S. pension fund take if investments overseas are to be as safe as investments in the United States?

Answer

There are major differences in both the quantity and quality of disclosure of information in securities markets outside the United States. Thus, a manager of a U.S. pension fund investing overseas generally should make a thorough examination on their own of a prospective investment; and retain competent advisers to assist in an evaluation of any such overseas investment, have an understanding of the differences between U.S. and accounting standards of the domicile of the foreign issuer.

QUESTION FROM SENATOR RIEGLE

Question 2.

What do you think should be the role, if any, of the Securities and Exchange Commission and the government in attempting to harmonize standards of securities regulation worldwide and in attempting to facilitate international settlement facilities, international consolidated reporting, consolidated quotations and intermarket linkages?

Answer

The SEC, as the U.S. body charged with regulating U.S. securities markets and protecting investors in those markets, clearly should have a central role in any efforts to harmonize the laws and practices of foreign countries and to link their facilities with our own. Other key participants would include Congress and the Treasury and State Departments.

QUESTIONS FROM SENATOR GARN

Question 3.

Looking at the historical safety of the Euromarkets, does it make sense generally to have different regulatory procedures for transactions among sophisticated institutions as opposed to transactions involving individuals and smaller institutions?

Answer

Yes, sophisticated institutions are in a position to make their own analysis and need not rely soley on the representation of the issuer and others.

Question 4.

Do you support the eventual development of a common regulatory or disclosure system for participants in international capital markets?

Answer

The New York Stock Exchange has supported the SEC's initiatives to develop a reciprocal approach to multi-national offerings. The comment letters to the Commission from the Exchange's International Capital Markets, Listed Company and European Advisory Committees of the Exchange's Board of Directors all supporting the reciprocal prospectus or disclosure concept, are enclosed.

Qeustion 5.

How would you recommend changing the U.S. regulatory structure to increase our competitive position in world markets without threatening the safety and integrity of the financial system?

Answer

As suggested in my testimony, a balance needs to be achieved which assures adequate information to the investor and regulation of the markets on which he trades.

A review should be made of existing regulatory requirements in the U.S. and elsewhere with a view towards retaining only essential regulations on world markets.

The New York Stock Exchange is undertaking such a review of its rules as explained in the attached information memo announcing the formation of a Market Regulation Review Committee.

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

January 31, 1984

The Honorable Thomas P. O'Neill, Jr.
The Speaker
U. S. House of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

I am pleased to transmit, on behalf of the Securities and Exchange Commission, the attached proposal to amend the Investment Company Act of 1940 to make it easier for the Commission to permit an operating foreign investment company to register under the Act and sell its shares in the United States, when the Commission finds this to be consistent with the purposes of the Act and the protection of investors.

The views expressed in the accompanying materials are those of the Commission and do not necessarily express the views of the President. These materials are being submitted simultaneously to the Office of Management and Budget ("OMB"). We will inform you of any advice received from OMB concerning the relationship of these materials to the program of the Administration.

Sincerely,

J Shad

John S.R. Shad

Enclosure

cc: James M. Frey
Asst. Director for
Legislative Reference
Office of Management and Budget

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION IN SUPPORT OF THE FOREIGN INVESTMENT COMPANY AMENDMENTS ACT OF 1984

A. Introduction: Need for Legislation

The Commission is recommending that the Congress amend the Investment Company Act of 1940 (the "Act") to remove unnecessary and anticompetitive barriers to the sale in the United States of the securities of foreign investment companies which primarily invest in securities of non-United States issuers. Currently, Section 7(d) of the Act tends to operate in a way that prevents foreign investment companies from registering under the Act and offering their shares in the United States. The consequences too often are needless costs and insurmountable barriers to foreign companies seeking access to United States markets, lost competitive opportunities, and a denial of investment opportunities for United States investors.

Despite the Commission's publication of guidelines to assist foreign investment companies in meeting the requirements of Section 7(d), the section has too often operated as a practical and legal barrier to foreign companies' gaining access to United States securities markets. That result may not have been particularly troublesome in the past, when the securities markets were predominantly national in character. Today, however, the securities markets are far more international. Investors, living in one country, are increasingly interested in the securities of companies located in other countries. United States securities firms seek opportunies to do business abroad while non-United States owned securities firms are now members of United States securities exchanges. Where possible, United States investment companies are selling their shares abroad to foreign investors. Modern technology and communications systems have made these developments feasible. As competition continues to expand on an international level, national regulatory schemes may need to be adapted to reflect these changes. Conflicts among the regulatory systems of different nations unreasonably impede the natural development of international markets and competition. Section 7(d) currently operates in such a restrictive manner.

Section 7(d): The Current Prohibition On Foreign Investment Companies Selling Shares In The United States

Section 7(d) of the Act currently prohibits foreign investment companies from offering their shares in the United States unless the Commission issues an order permitting them to register under the Act and make such an offering. Under the section, such an order must be based on a finding that "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors." In 1975, the Commission published an interpretive release ("Guidelines") setting forth its policy and guidelines for filing an application for an order under Section 7(d). The Guidelines included an analysis of the standards foreign investment companies should meet in order to enable the Commission to make the required findings under Section 7(d). 1/

The Commission recognized in the Guidelines that differences in foreign law and capital markets may make it difficult or impossible for foreign investment companies to comply literally with all the requirements of the Act or with those of Rule 7d-1 under the Act [17 CFR §270.7d-1]. 2/ Accordingly, the Guidelines indicated that the Commission would, notwithstanding the absence of compliance with all of the provisions of the Act, accept applications for orders pursuant to Section 7(d) and, where necessary, grant exemptive relief from particular provisions of the Act pursuant to Section 6(c) of the Act [15 U.S.C. §80a-6(c)]. 3/ The Guidelines further stated, however, that any foreign investment company requesting an order under Section 7(d) should, at a minimum, demonstrate: (A) that the protections accorded to investors by the legal and regulatory system under which it operates are substantially equivalent to applicable provisions of the

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1/ Investment Company Act Release No.8959 (September 2, 1975), 40 F.R. 45424, Commission Policy and Guidelines for Filing of Application for Order Permitting Registration under the Act and Sale of Shares in the United States of Foreign Investment Companies.

2/ Rule 7d-1 provides, in general, that a Canadian management investment company may obtain an order pursuant to Section 7(d) if it complies with certain specified conditions and arrangements listed in the rule and designed to ensure the enforceability of the Act against such a company. It also states that "conditions and arrangements proposed by investment companies organized under the laws of other countries will be considered by the Commission in the light of the special circumstances and local laws involved in each case." While the rule addresses Canadian investment companies, it provides a model of the types of conditions and arrangements that should exist for the Commission to make the necessary findings under Section 7(d).

3/ Section 6(c) provides that "the Commission. . . may conditionally or unconditionally exempt any person, security or transaction, or any class or classes of persons, securities or transactions from any provision or provisions of [the Act] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act]."

Act; and (B) that, in conformity with standards listed in the Guidelines, it (1) is a bona fide and established company, (2) is subject to actual regulation by an appropriate governmental authority, (3) would not be dependent solely on sales in the United States, (4) would be a vehicle for investment primarily in foreign securities, (5) would subject itself and its management to service of process in the United States, and (6) would provide adequate disclosure in the United States.

Inability of Foreign Investment Companies to Gain Access to United States Securities Markets

The Commission believes that it is important that the Congress amend Section 7(d) to give the Commission greater flexibility to recognize differences in regulatory treatment from nation to nation, and to fashion regulatory approaches for foreign investment companies based on principles of international comity. It always will be important to assure that United States investors receive protection from the abuses that the Act addresses. Nevertheless, the regulatory schemes of other nations may provide protections for investors which serve the same purposes as the protections provided by the Act, and the Commission's staff could work with foreign investment companies and foreign regulatory authorities to fashion workable regulatory approaches for companies doing business internationally without sacrificing investor protection. Unfortunately, Section 7(d) in its current form presents difficult barriers to the development of workable solutions to the problems of international securities markets for investment companies. Because they operate under different cultural and legal systems, foreign investment companies sometimes must comply with laws that conflict with the Act's requirements or must be structured differently from United States investment companies. The Commission's experience has demonstrated that a foreign investment company may in fact need extensive exemptive relief from the Act in order to function in a manner consistent with its own domestic laws and business practices. For example, exemptions may be necessary to reconcile the Act's corporate governance provisions, which are based on a concept of disinterested directors, with foreign law, which may not contemplate such a concept. 4/ While United States law certainly should not and would not always bend to the requirements and values of foreign laws, Section 7(d) affords the Commission little

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4/ See e.g., Section 10(a) of the Act [15 U.S.C. §80a-10(a)], which requires that at least 40 percent of an investment company's board of directors be persons who are not "interested persons" of the company as that term is defined in Section 2(a)(19) of the Act [15 U.S.C. §80a-2(a)-19)]; and Section 15(c) of the Act [15 U.S.C. §80a-15(c)], which requires that any underwriting or investment advisory agreement entered into by an investment company must be approved by a majority of its directors who are not parties to the agreement or "interested persons" of any party.

opportunity to seek reasonable accommodations since it requires a finding that the Act will be legally and practically enforceable against the foreign company. Where foreign regulatory systems would provide investor protections which serve the same purposes as those provided by the provisions of the Act from which exemption is requested, the Commission believes it should have greater flexibility to fashion rules and orders to permit foreign investment companies subject to those regulatory systems to sell their shares in the United States.

As noted above, the Commission believes that Section 7(d) creates unwarranted difficulties for a foreign investment company which desires to sell its shares in the United States. It seems likely that these companies will continue to submit applications to the Commission, but because the companies operate in legal or regulatory environments different from the Act, the requisite statutory findings will be difficult or impossible to make. Therefore, the Commission is recommending legislation to amend Section 7(d) of the Act in order to permit a foreign investment company to offer its shares in the United States, even if it would not be literally possible to enforce all the provisions of the Act against that company, provided that arrangements exist which would protect investors satisfactorily.

B. The Commission Proposal

The Commission's proposed amendment to Section 7(d) will facilitate access to U.S. securities markets by responsible foreign investment companies primarily engaged in investing in securities of non-United States issuers when such companies are subject to laws of foreign countries which provide protections which serve the same purposes as those provided by the provisions of the Act from which exemption is requested.

As described above, Section 7(d) currently requires a Commission finding that it is both legally and practically feasible to enforce the provisions of the Act against a foreign company interested in registering under the Act and making a public offering of its securities by use of the mails or other means of interstate commerce. Under the proposed amendments to Section 7(d), the Commission would be authorized to grant exemptions with respect to an operating foreign investment company from those provisions of the Act with which the Commission finds compliance to be unduly burdensome, given the nature of the company. The Commission also must find either that the laws under which the company operates provide protections for investors which serve the same purposes as the protections provided by the provisions of the Act from which exemption is requested or that specific conditions agreed to by the company provide such protections. Such protections would not have to be the same as those provided by the provisions from which exemption is requested, but would have to have the same purposes. In addition, the Commission would have to find that an exemption is consistent with the protection of investors and the purposes fairly intended by the policy of the Act and that the company is not operated for the purpose of evading the provisions of the Act.

An operating foreign investment company would be defined as a company organized or created under the laws of a foreign country which has been in operation, with a minimum of 500 non-United States shareholders and $100 million in net assets, for a period of three years or more, and which is primarily engaged in investing in securities of non-United States issuers. The Act, as amended, would allow the Commission to permit an operating foreign investment company to register under the Act and make a public offering of its securities in the United States upon finding that it is possible to enforce against the company those provisions of the Act from which exemption has not been granted.

Under the amended Section 7(d), the Commission would be authorized to revoke or modify any order issued under the subsection with respect to an investment company organized or otherwise created under the laws of a foreign country if it finds that (1) it is not legally and practically feasible effectively to enforce the provisions of the Act, to which such a company is subject, against the company, or that (2) a company exempted from any provision of the Act as an operating foreign investment company is not primarily engaged in investing in securities of non-United States issuers, or that (3) the laws under which an operating foreign investment company operates do not provide investor protections which have the same purposes as those provided by the sections of the 1940 Act from which exemption has been granted or that specific conditions agreed to by the company do not provide such investor protections.

The Commission's proposal would provide the Commission with much-needed flexibility for the development of rules and orders permitting registration of foreign investment companies without sacrificing investor protection.

C. Conclusion

The Commission believes that enactment of the Foreign Investment Company Amendments Act of 1984 would recognize the increasingly international character of the securities markets and give the Commission necessary authority to fashion regulatory requirements that will protect investors while permitting them to invest in operating foreign investment companies. The legislation will modify the stringent 'enforceability' standard of Section 7(d) with a more flexible standard. For the foregoing reasons, the Commission strongly urges that Congress enact the Foreign Investment Company Amendments Act of 1984.

A BILL

To amend the Investment Company Act of 1940.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. That this Act may be cited as "The Foreign Investment Company Amendments Act of 1984."

Section 2. Section 7(d) of the Investment Company Act of 1940 (15 U.S.C. 80a-7(d)) is amended by adding at the end thereof the following:

> :*Provided*, however, that with respect to an operating foreign investment company, the Commission may by rule or order grant exemption from any provision of this title if it finds that (1) compliance with such provision would be unduly burdensome because the company is organized or otherwise created under foreign law and invests primarily in foreign securities, (2) the laws under which such company operates provide protections for investors which serve the same purposes as the protections provided by the provisions of this title from which exemption is requested or that specific conditions agreed to by the company provide such investor protections, (3) the exemption is consistent with the protection of investors and the purposes fairly intended by the policy of this title, and (4) such company is not operated for the purpose of evading the provisions of this title. For purposes of this subsection, an operating foreign investment company is a company organized or created under the laws of a foreign country which at all times during the three year period immediately preceding the filing of an application for registration under this title has had a minimum of 500 non-United States shareholders and $100 million in net assets, and which is primarily engaged in investing in securities of non-United States issuers.
>
> The Commission, upon its own motion or upon application, may by order revoke or modify any order issued under this subsection with respect to an investment company organized or otherwise created under the laws of a foreign country whenever it shall find that (1) it is not legally and practically feasible effectively to enforce the provisions of this title, to which such a company is subject, against the company, (2) a company exempted from any provision of this title as an operating foreign investment company is not primarily engaged in investing

in securities of non-United States issuers, or (3) the laws under which an operating foreign investment company operates do not provide investor protections which have the same purposes as the protections provided by the provisions of this title from which exemption has been granted or that specific conditions agreed to by the company do not provide such investor protections.

Section 3. The amendments made by this Act shall become effective upon enactment.

SECTION-BY-SECTION ANALYSIS

SECTION 1. The Act may be cited as "The Foreign Investment Company Amendments Act of 1984."

SECTION 2. Section 7(d) of the Investment Company Act of 1940 ("1940 Act") currently prohibits an investment company organized or otherwise created under the laws of a foreign country from registering under the 1940 Act and making a public offering of its securities by use of the mails and means or instrumentalities of interstate commerce unless the Commission finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of the 1940 Act against such company and that the issuance of an order permitting such registration and offering is otherwise consistent with the public interest and the protection of investors.

The Act amends Section 7(d) to authorize the Commission, with respect to an operating foreign investment company, to grant, by rule or order, exemption from any provision of the 1940 Act if the Commission makes the following findings: (1) by reason of the company being an operating foreign investment company (as that term is defined in the Act), compliance with the provision would be unduly burdensome, (2) either the laws under which the company operates provide protections for investors which serve the same purposes as the protections provided by the provisions of the 1940 Act from which exemption is requested or specific conditions agreed to by the company provide such investor protections, (3) an exemption is consistent with the protection of investors and the purposes fairly intended by the policy of the 1940 Act, and (4) the company is not operated for the purpose of evading the provisions of the 1940 Act.

An operating foreign investment company is defined, for purposes of Section 7(d) of the 1940 Act, as a company which (i) was organized or created under the laws of a foreign country, (ii) has had a minimum of 500 non-United States shareholders and $100 million in net assets at all times during the three year period immediately preceding the filing of an application for registration under the 1940 Act, and (iii) is primarily engaged in investing in securities of non-United States issuers.

Thus, the Act will enable the Commission to permit an operating foreign investment company to register under the 1940 Act and offer to sell its securities in the United States markets if the Commission finds that it is both legally and practically feasible effectively to enforce against such company those provisions of the 1940 Act from which exemptions have not been granted.

In addition, under the amended Section 7(d), the Commission would be authorized to revoke or modify any order issued under the subsection with respect to any investment company organized or otherwise created under the laws of a foreign country if it finds that (1) it is not legally and practically feasible effectively to enforce the provisions of the 1940 Act, to which such a company is subject, against the company, or that (2) a company exempted from any provision of the 1940 Act as an operating foreign investment company is not primarily engaged in investing in securities of non-United States issuers, or that (3) the laws under which an operating foreign investment company operates do not provide investor protections which have the same purposes as those provided by the sections of the 1940 Act from which exemption has been granted or that specific conditions agreed to by the company do not provide such investor protections.

Section 3. The Act is to become effective upon enactment.

OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

January 31, 1984

The Honorable Paul S. Sarbarnes
United States Senate
Washington, D.C. 20510

Dear Senator Sarbanes:

I am pleased to transmit, on behalf of the Securities and Exchange Commission the attached proposal to amend the Investment Company Act of 1940 to make it easier for the Commission to permit an operating foreign investment company to register under the Act and sell its shares in the United States, when the Commission finds this to be consistent with the purposes of the Act and the protection of investors.

The views expressed in the accompanying materials are those of the Commission and do not necessarily express the views of the President. These materials are being submitted simultaneously to the Office of Management and Budget ("OMB"). We will inform you of any advice received from OMB concerning the relationship of these materials to the program of the Administration.

Questions concerning the proposed legislation can be directed to either Ethel Geisinger, Director of Legislative Affairs, at 272-2500 or to Kathryn B. McGrath, Director, Division of Investment Management, at 272-2750.

Sincerely,

John Shad

John S.R. Shad

Enclosure

17 CFR Part 271

[Release No. IC-13691]

Applications of Foreign Investment Companies Filed Pursuant to Section 7(d) of the Investment Company Act of 1940

AGENCY: Securities and Exchange Commission.

ACTION: Statement of Commission position.

SUMMARY: The Securities and Exchange Commission advises any foreign investment company domiciled in a civil law country which desires to sell its shares in the United States to consider organizing a separate company in the United States and offering the latter's shares in this country instead of filing an application under Section 7(d) of the Investment Company Act of 1940 ("Act") for permission to register under the Act and sell its own shares. The Commission makes this suggestion because of the difficulties a foreign company may face in meeting the existing requirements of the Act. The Commission also announces that it is recommending legislation to the Congress to amend Section 7(d) of the Act to make it easier for operating foreign investment companies to register with the Commission when that is consistent with the purposes of the Act and the protection of investors.

EFFECTIVE DATE: December 23, 1983.

FOR FURTHER INFORMATION CONTACT: Glen A. Payne, Assistant Director (202) 272-3018, Mary A. Cole, Special Counsel (202) 272-3023, or Brian M. Kaplowitz, Staff Attorney (202) 272-3024, Division of Investment Management, Securities and Exchange Commission, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") has determined to issue the following release in order to describe problems that certain foreign investment companies may encounter in filing applications for orders under Section 7(d) of the Investment Company Act of 1940 ("Act") [15 U.S.C. 80a-7(d)], and to suggest that any such company desiring to offer its shares for sale in the United States should consider forming a separate company in the United States and offering the latter's shares.

Background

Section 7(d) of the Act prohibits foreign investment companies from offering their shares in the United States unless the Commission issues an order permitting them to register under the Act. Under the section, the Commission must find that "by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of [the Act] against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors." In 1975, the Commission published an interpretive release ("Guidelines") setting forth its policy and guidelines for filing an application for an order under Section 7(d). The Guidelines included an analysis of the standards foreign investment companies should meet in order to enable the Commission to make the finding required by Section 7(d).[1] This release supplements the Guidelines.

The Commission recognized in the Guidelines that differences in foreign law and capital markets may make it difficult or impossible for foreign investment companies to comply with all the requirements of the Act or with those of Rule 7d-1 under the Act [17 CFR 270.7d-1].[2] Accordingly, the Commission indicated that it would entertain applications for orders pursuant to Section 7(d) and, where necessary, grant exemptive relief from other provisions of the Act pursuant to Section 6(c) of the Act [15 U.S.C. 80a-6(c)].[3] The Commission further stated, however, that any foreign investment company requesting an order under Section 7(d) should, at a minimum, demonstrate: (a) That the protections accorded to investors by the legal and regulatory system under which it operates are substantially equivalent to provisions of the Act; and (b) that, in conformity with standards listed in the Guidelines, it: (1) Is a bona fide and established company; (2) is subject to actual regulation by an appropriate governmental authority; (3) would not be dependent solely on sales in the United States; (4) would be a vehicle for investment primarily in foreign securities; (5) would subject itself and its management to service of process in the United States; and (6) would provide adequate disclosure to investors in the United States.

Only one foreign investment company has filed an application (which was subsequently withdrawn) for an order allowing it to sell its shares in the United States based on the Guidelines. However, the processing of that application made apparent certain difficulties, discussed below, that foreign investment companies, particularly those organized in civil law countries, may encounter in attempting to register under the Act pursuant to Section 7(d).

Discussion

The structure and operations of foreign investment companies, as well as the legal, regulatory and business environment in which they operate, can present varied and unforeseen problems in light of the mandate of Section 7(d) of the Act. For example, the Guidelines make clear that the foreign investment company and its managers are to consent to United States jurisdiction. However, the business practices and customs of a particular country may make it difficult or impossible for a foreign company to get its managers to accept personal liability by submitting to United States jurisdiction. The inability to submit to the jurisdiction of United States courts makes it difficult for the Commission to find under Section 7(d) that the Act would be legally enforceable against the applicant. Another problem may arise from the applicant's inability to comply with many of the provisions of Rule 7d-1. While that rule addresses Canadian investment companies and strict adherence to the rule therefore is not required, nonetheless, Rule 7d-1 provides guidance as to the types of conditions or arrangements that the Commission may rely on to support a determination to permit foreign investment companies to offer their shares in the United States.

The Commission's experience has also demonstrated that, beyond the Section 7(d) considerations, a foreign investment company may need extensive exemptive relief pursuant to Section 6(c) of the Act in order to function in a manner consistent with its own domestic laws and business practices. For example, exemptions may be necessary to reconcile the Act's corporate governance provisions, which are based on a concept of disinterested directors, with foreign law, which may not contemplate such a concept.[4]

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[1] Investment Company Act Release No. 8959 (September 29, 1975) [40 FR 45424, October 2, 1975], Commission Policy and Guidelines for Filing of Application for Order Permitting Registration under the Act and Sale of Shares in the United States of Foreign Investment Companies.

[2] Rule 7d-1 provides, in general, that a Canadian management investment company may obtain an order pursuant to section 7(d) if it complies with certain specified conditions and arrangements listed in the rule and designed to ensure the enforceability of the Act against such a company. It also states that "conditions and arrangements proposed by investment companies organized under the laws of other countries will be considered by the Commission in the light of the special circumstances and local laws involved in each case."

[3] Section 6(c) provides that "the Commission * * * may conditionally or unconditionally exempt any person, security or transaction, or any class or classes of persons, securities or transactions from any provision or provisions of [the Act] or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Act]."

Finally, a number of practical difficulties may arise in the context of a Section 7(d) application. Among such difficulties are the possible inability to obtain English translations of all applicable foreign laws and the delays inherent in communicating with and obtaining information and documents from foreign entities. In addition, there exists the problem of jurisdictional sensitivity which may be involved in inquiring into the operations and effectiveness of foreign regulatory bodies. Such an inquiry may be necessary so that the Commission can determine whether the applicable foreign system affords United States investors protections substantially equivalent to those provided by the Act, a determination required by the Guidelines.[5]

Resolution of problems of this type normally will involve time delays and significant legal and other expenses. For this reason, the Commission urges any foreign investment company operating in a legal or regulatory environment which differs significantly from the Act and which wants to sell its shares in the United States to consider forming a separate United States company and offering the latter company's shares instead of seeking an order under Section 7(d) of the Act.[6] Formation of a United States "mirror fund", *i.e.*, a United States investment company investing primarily in the securities of foreign issuers in which the foreign investment company invests, would enable a foreign investment adviser to offer its services to United States investors without the need for registration of the foreign investment company under Section 7(d). Organization of such a surrogate fund appears to be the most expeditious and least costly way to accomplish the objectives of a foreign investment adviser wishing to offer shares of a foreign investment company in the United States. It would avoid the need for the extensive exemptions that otherwise would be needed for such a foreign company to directly offer its shares in this country. In this regard, it should be noted that the Commission did not intend, when it issued the Guidelines, that foreign investment companies should rule out the possibility of using alternatives other than applications under Section 7(d).[7]

The Commission also wishes to emphasize that, in suggesting the above procedures, it is not criticizing any foreign regulatory system. The difficulties lie in the specific legal finding the Commission must make under Section 7(d) of the Act. Because the Commission believes that the present standards in Section 7(d) of the Act present unnecessary obstacles to operating foreign investment companies the Commission will recommend that the Congress amend the standards of Section 7(d) to make it easier for such companies to register and sell shares in this country when that is consistent with the purposes of the Act and the protection of investors.

List of Subjects in 17 CFR Part 271

Investment companies, Securities.

Accordingly, 17 CFR Part 271 is hereby amended by adding a reference to this statement of Commission position.

By the Commission.

Dated: December 23, 1983.

George A. Fitzsimmons,

Secretary.

[FR Doc. 83-[illegible] Filed 12-[illegible]; 8:45 am]

BILLING CODE 8010-01-M

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[4] *See e.g.*, Section 10(a) of the Act [15 U.S.C. 80a-10(a)], which requires that at least 40 percent of an investment company's board of directors be persons who are not "interested persons" of the company as that term is defined in Section 2(a)(19) of the Act [15 U.S.C. 80a-2(a)(19)]; and Section 15(c) of the Act [15 U.S.C. 80a-15(c)], which requires that any underwriting or investment advisory agreement entered into by an investment company must be approved by a majority of its directors who are not parties to the agreement or "interested persons" of any party.

[5] *See* pages 3-4, *supra*.

[6] The Commission notes that certain foreign investment advisers in civil law countries have organized United States companies whose portfolios consist of securities traded outside of the United States. *See e.g.*, Mexico Fund, Inc., Investment Company Act Registration No. 811-3170, Securities Act of 1933 Registration No. 2-86227, a Maryland corporation advised by Impulsora del Fondo Mexico, S.A. de C.V., a Mexican corporation; Nomura Index Fund of Japan, Inc., Investment Company Act Registration No. 811-3813, Securities Act of 1933 Registration No. 2-80999, a Maryland Corporation sponsored by Nomura Securities Co., a Japanese securities firm which, through various subsidiaries, acts as investment adviser and principal underwriter to Nomura Index Fund. *Cf.* G.T. Pacific Fund, Inc., Investment Company Act Registration No. 811-3669; Securities Act of 1933 Registration No. 2-67528, a California company investing primarily in securities of issuers of Far Eastern countries and advised by a subsidiary of an English company.

[7] A further potential problem that an applicant under Section 7(d) should anticipate is the filing with the Commission of a request for a hearing by other parties. Even if the Commission ultimately issues a notice of an application, the Act affords "interested persons" the right to make such request. In that event, the Commission may conclude that, because of the matters raised in the hearing petition, the provisions of the Act and considerations of due process and fairness require or make it appropriate that it convene a hearing.

[Release No. 13682; 812-5700]

European Development Capital Limited Partnership; Application

December 29, 1983.

Notice is hereby given that European Development Capital Limited Partnership ("Applicant"), 767 Third Avenue, New York, NY 10017, a limited partnership under the laws of New York, filed an application on November 18, 1983, for an order of the Commission pursuant to Section 6(c) of the Investment Company Act of 1940 ("Act") exempting Applicant from all provisions of the Act. All interested persons are referred to the application on file with the Commission for a statement of the representations contained therein, which are summarized below, and to the Act for the text of all applicable sections.

Information Memo

NYSE
New York
Stock Exchange, Inc.

11 Wall Street
New York, NY 10005

Market Surveillance Services

Number 86-1

January 23, 1986

TO: All Members and the Managing Partner/Chief Executive Officer of Each Member Organizations

SUBJECT: Review of Market Trading Regulations

The Exchange's Board of Directors recently approved the establishment of a special Market Regulation Review Committee to review and develop recommendations for updating Exchange market trading regulations in a manner consistent with maintaining market integrity and protecting public investors. The Committee will be co-chaired by Norman Schlanger, a specialist partner of Hirshon, Roth & Co., and Thomas Ryan, Vice President of Kidder, Peabody, & Co. Inc. The composition and members of the Committee are set forth in the Attachment to this bulletin.

Many Exchange trading rules, as well as certain provisions of the Securities Exchange Act and SEC rules promulgated thereunder, were adopted years ago to regulate a trading environment that is substantially different from today's high volume, block-oriented markets. These regulations pre-date modern, sophisticated surveillance tools such as the Exchange's audit trail, and in a number of instances the rules may no longer serve a meaningful regulatory purpose. The Exchange believes it may be possible to modify a number of these regulations without any loss of essential public investor protections in this market.

The Market Regulation Review Committee will be reviewing the following:

(i) Exchange general auction market rules;

(ii) Exchange market trading and order handling rules applicable to all members generally;

(iii) Exchange market trading rules applicable to specialists;

(over)

(iv) Exchange market trading rules applicable to non-specialist members seeking to initiate proprietary orders on the Floor or effect proprietary transactions on the Exchange;

(v) Inter-market (ITS) trading rules; and

(vi) Provisions of the Securities Exchange Act of 1934 and regulations promulgated thereunder by the Securities and Exchange Commission which regulate trading on the Exchange.

The Committee will report to the Exchange Board's Quality of Markets Committee and it will be expected to recommend appropriate changes to market trading regulation, in a manner consistent with maintaining market integrity and protecting public investors, to enable the Exchange to:

(i) stimulate intra-market competition by providing enhanced trading opportunities for all Exchange market participants; and

(ii) eliminate requirements that no longer serve a meaningful regulatory purpose and may impose unnecessary restraints on the Exchange's ability to compete with other markets.

The Committee will begin its work in January, 1986, with the entire regulatory review initiative expected to last approximately 18 months. Before any final action is taken by the Exchange's Board of Directors, the Committee's recommendations will be exposed to Exchange constituents for comment.

Members and member organizations wishing to make any preliminary comment that they believe may be helpful to the Committee as it begins its work should address their views to Donald J. Solodar, Senior Vice President, New York Stock Exchange, 11 Wall Street, New York, New York 10005. Telephone inquiries may be directed to Santo Famularo (212) 623-2074 or Brian McNamara (212) 623-7086.

Attachment

Members of Market Regulation Review Committee

REPRESENTATIVES OF SPECIALIST ORGANIZATIONS

Norman Schlanger (Co-chairman)
Partner
Hirshon, Roth & Co.

William R. Johnston
Chief Executive Officer
Agora Securities, Inc.

Robert J. Silver
Partner
B.E.S. Partners

BROKER REPRESENTATIVES OF MEMBER ORGANIZATIONS DOING A PUBLIC BUSINESS

Pat Marchese
Senior Vice President
E.F. Hutton & Company, Inc.

Herman H. Weiss
Shearson Lehman/American Express Inc.

William W. Prager, Jr.
Kalb, Voorhis & Co.

Arthur D. Cashin, Jr.
Vice President
Painewebber Incorporated

INDEPENDENT BROKERS

David Shields

Richard Rosenblatt

NON-SPECIALIST FLOOR TRADER

Robert Brooks

MEMBER FIRM "UPSTAIRS" TRADERS

Hugh P. Lowenstein
Administrative Managing Director
L.F. Rothschild, Unterberg, Towbin

Thomas F. Ryan, Jr. (Co-chairman)
Vice President
Kidder, Peabody & Co., Inc.

(over)

PUBLIC INSTITUTIONAL TRADER

Joseph A. DeMarco
Vice President - Equity Trading
Marine Midland Bank, N.A.

MEMBER ORGANIZATION OPERATIONS MANAGERS

William J. Tierney, Jr.
Managing Director
Salomon Brothers, Inc.

Melvin B. Taub
Division Vice President
Merrill Lynch, Pierce, Fenner & Smith Inc.

NYSE REGULATORY SERVICES GROUP

David Marcus
Executive Vice President

Donald Solodar
Senior Vice President - Market Surveillance Services

11 Wall Street
New York, NY 10005

LISTED COMPANY ADVISORY COMMITTEE
TO THE NYSE BOARD OF DIRECTORS

EXHIBIT 2

NYSE
New York
Stock Exchange, Inc.

Members

Theodore F. Brophy
GTE Corporation
(Committee Chairman)

Samuel H. Armacost
BankAmerica Corporation

George M. Berman
Unitrode Corporation

W. J. Biggers
American Business Products, Inc.

*Fletcher L. Byrom
Koppers Company, Inc.

T. J. Dermot Dunphy
Sealed Air Corporation

Laurence J. Farley
The Black & Decker Corporation

Howard Goldfeder
Federated Department Stores, Inc.

Maurice R. Greenberg
American International Group, Inc.

Fred L. Hartley
UNOCAL Corporation

Leonard G. Herring
Lowe's Companies

Karl F. Hoenecke
Federal Signal Corporation

Herbert D. Kelleher
Southwest Airlines Co.

Vernon R. Loucks, Jr.
Baxter Travenol Laboratories, Inc.

Marshall McDonald
Florida Power & Light Company

Akio Morita
Sony Corporation

Sergio Orlandini
KLM Royal Dutch Airlines

W. J. Sanders, III
Advanced Micro Devices, Inc.

John G. Smale
The Procter & Gamble Company

Hicks B. Waldron
Avon Products, Inc.

John F. Welch
General Electric Corporation

*Ex-officio NYSE Directors

July 12, 1985

Mr. John Wheeler
Secretary
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

File No. S7-9-85

Dear Mr. Wheeler:

The NYSE Listed Company Advisory Committee has asked me to comment in their behalf on the SEC's timely release on the Facilitation of Multinational Securities Offerings (Release No. 33-6568).

Our Committee strongly supports the Commission's initiative in taking steps to facilitate multinational securities offerings among the U.K., Canada and the U.S. Harmonization of disclosure requirements would be an important step in easing the capital raising problems of major U.S. issuers. They could search out the best world markets for their issues without undue consideration for regulatory requirements. This would move us much closer to the model of an ideal market where decisions are based only on economics.

U.S. issuers would find it easier to meet heavy capital requirements at a lower cost and in a shorter time. This would not only benefit U.S. corporations, but ultimately should help improve U.S. economic performance. On the other hand, if the Commission does not move forward with proposals such as those in its release, it could place U.S. issuers at a competitive disadvantage in making offerings in the U.K. and Canada.

Our Committee recommends that the SEC extend its proposal to include Japan as well as the U.K. and Canada. Japan will be assuming an increasing role in the international marketplace as it deregulates its financial markets. Harmonization of disclosure requirements with Japan should ease the way for U.S. corporations as the Japanese capital markets become more accessible to foreign issuers.

In conclusion, it seems to the Committee that the Commission's initiative moves us closer to a truly global market. It promises not only to ease the financing problems of large U.S. issuers, but in the longer run to contribute to better economic performance in the U.S. and abroad.

The Committee wishes to thank the SEC for the opportunity to comment on an issue of keen interest to us.

Respectfully submitted,

Theodore F Brophy

Committee Chairman

European Advisory Committee
to the
NYSE Board of Directors

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KLM Royal Dutch Airlines
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NYSE
New York
Stock Exchange, Inc.

January 31, 1986

The Honorable John S. R. Shad
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Shad:

On behalf of the European Advisory Committee to the Board of Directors of the New York Stock Exchange, Inc. ("EAC"), I want to convey the Committee's support of the Commission's initiative in its concept release on "Facilitation of Multinational Offerings."

By way of background, the EAC presently consists of 13 active or former chief executive officers of European-based companies or financial institutions and is charged with the duties of providing to the NYSE Board of Directors the representative views and attitudes of the European corporate community on the role of the NYSE in international matters. Among the items discussed at our recent organizational meeting in London, were the changing environment in global securities markets, especially new sources of corporate financing in international markets. Accordingly, we applaud the Commission's initiative in pursuing the objectives set forth in its Release No. 33-6568 and recognize its effort to reconcile the rules, regulations and customary practices to which the markets in various countries may be uniquely subject.

While we agree that broad requirements in the U.S., U.K. and Canada, for complete and accurate disclosure of both financial and non-financial information would facilitate multinational offerings, we believe that the implementation of a common prospectus requiring uniformity across international borders would be impractical. Extensive negotiation among the major markets would be necessary to settle upon a mutually acceptable prospectus and continual negotiation of these standards would be required as changes occur in the business and industrial climate of various countries. Moreover, the danger of a common prospectus is that the final result will be an unjustifiable accumulation of all the requirements now valid in the different countries. In short, the common prospectus approach would become more untenable if the ultimate aim is to embrace not only the U.S., Canada and the U.K. but also the fifteen other countries that are identified with companies whose securities trade internationally.

In our opinion, the "reciprocal prospectus" described in the Commission's concept release is the most promising approach to resolving disparities in existing disclosure standards. Under this procedure, a prospectus acceptable by an issuer's domicile would also be acceptable for a simultaneous offering in a participating country, subject to compliance with certain additional disclosure standards. Among other things, the standards would include a reconciliation of differences between the accounting standards used by the issuer and the standards in other countries where the offering is eligible to take place.

We recommend diligent efforts be made to develop flexible guidelines within which participating markets can thrive and further suggest the SEC move toward accepting the prospectus of any company recognized for trading on a European Exchange which meets specific continued listing requirements. In our opinion, that would be the most direct route for the Commission to address the rapidly growing trend of U.S. corporations who now seek economically competitive global markets for their issues.

A key objective of the Commission policy on the facilitation of multinational offerings should be to permit fair competition among the three centers while recognizing the differences in national requirements. Decisions by investors and issuers as to which market to choose should be based on economic factors, not regulatory differences.

The rapid growth of a "world economy" suggests the need for a mechanism that will foster efficient and effective multinational securities offerings. We believe it is appropriate for the Commission to work with other authorities in Europe in the pursuit of this goal and open a dialogue on the internationalization of securities offerings. Our Committee is willing to assist the Commission in this important effort.

Sincerely,

Sergio Orlandini

Sergio Orlandini
Chairman

cc: John Huber

11 Wall Street
New York, NY 10005

Advisory Committee on
International Capital
Markets to the
NYSE Board of Directors

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*Founding Member: NYSE Director

NYSE
New York
Stock Exchange, Inc.

EXHIBIT 3

July 15, 1985

Mr. John Wheeler
Secretary
Securities and Exchange Commission
Washington, D.C. 20549

Securities Act Release No. 33-6568
Concerning Facilitation of Multinational
Securities Offerings File: S7-9-85

Dear Mr. Wheeler:

The International Advisory Committee to the New York Stock Exchange, Inc. (the "Committee"), appreciates this opportunity to comment on the above-referenced Release (the "Concept Release").

With the increasing acceleration in the internationalization of the capital markets, the Committee first wishes to applaud the Commission for both the timeliness and creativity of the Commission initiative embodied in the Concept Release. The Concept Release is an exceedingly important step in response to the recognition that we are nearing a critical crossroads in the development of the international capital markets. In the context of internationalization, the Commission in carrying out its mandate of protection of the U.S. investor through the provision of appropriate disclosure standards must also facilite access by U.S. investors to investment opportunities on a global basis.

Thus, in the Committee's view, the most important component of the Concept Release is its underlying premise that an important objective for the Commission is the reconciliation of the desirability of U.S. access to non-U.S. investment opportunities, on the one hand, with a retention, on the other hand, of the basic protections afforded by the securities laws which have been so important in developing investor confidence in the largest and most important market in the world -- here in the United States. The Committee believes that, at least initially, the ultimate key to success in this delicate task of reconciliation will be the coordination of the rules and regulations of the various major markets without necessarily making them completely uniform, and thereby to achieve an adequate level of equivalence to ensure the provision of information which is sufficient and as objective as practicable for actual or potential security holders.

From this perspective, the Committee is strongly of the view that the reciprocal prospectus concept described in the Concept Release is the most promising basic approach. As the Concept Release notes, the reciprocal approach has the advantage of avoiding extensive negotiations among the various major markets to settle upon a uniform, mutually acceptable prospectus. Even were it feasible to achieve initial agreement on uniform disclosure standards, the common prospectus approach has the added disadvantage of intrinsic rigidity. The changing perceptions of appropriate disclosure standards that naturally occur in response to changes in the business and investment climate in the various markets would require continual renegotiation.

While strongly in favor of the reciprocal concept, the Committee believes that the development of appropriate internationally accepted standards will best be served, at least initially, by implementation of the reciprocal prospectus concept with some measure of accommodation to the disclosure requirements of the jurisdiction in which a "reciprocal prospectus" is to be distributed. For example, in the United States, the Committee believes that a disclaimer such as the one suggested by the Concept Release in Question 15 would be an appropriate warning that the format and substance of the information contained in the prospectus are not the same as in a domestic prospectus. The Committee believes that a short supplement to the foreign prospectus which bridges the differences between certain of the foreign disclosure standards and traditional domestic disclosure standards will be important, at least in the near future, to the acceptability of the reciprocal prospectus package to investors as the basis for an investment decision. In the United States, this supplement to a foreign prospectus should consist of a representation that the issuer's auditors are independent accountants and that the audit has been carried out in conformity with United States Generally Accepted Auditing Standards, together with a reconciliation of the issuer's financial statements to U. S. Generally Accepted Accounting Principles (as now required by Form 20-F).

In order even for this modified reciprocal approach to serve as a catalyst to the further development of the international securities markets -- with full U.S. participation -- the Commission will have to deal successfully with two related issues: first, the extent to which the Staff would review a reciprocal prospectus before declaring the registration statement effective and, secondly, the extent to which the Commission will bring the periodic reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act") into line with the reciprocal prospectus approach.

The Committee believes that Staff review of a reciprocal prospectus need only be directed to that portion of the prospectus constituting the supplement. This is consistent with the premise that compliance with the form requirements of the foreign jurisdictions, in the core of the reciprocal prospectus, are the responsibility of the foreign issuer and its counsel and accountants. Protection of U.S. investors would rest, as it ultimately does with disclosures by domestic issuers, on the issuer's potential liability under Section 11 for omissions to state material facts or misleading statements of material facts. Staff review of the contents of the core prospectus as to compliance with rules of foreign jurisdictions would not only be unnecessary but also would tend to defeat the purpose of the reciprocal prospectus approach.

The reciprocal prospectus concept also would fall far short of its potential if appropriate accommodations are not made in the periodic reporting requirements under the Exchange Act. The objectives of the reciprocal approach could be frustrated if a foreign issuer were obligated to comply in its periodic reports with full U.S. standards. Rather, the Committee urges that the reciprocal concept be expanded to reporting under the Exchange Act so that foreign issuers would be permitted to report to the Commission on the basis of the form of reports used in their home jurisdictions, as such reports may be modified for SEC filing purposes to include a bridging supplement to U.S. reporting standards.

While the Concept Release focuses on simultaneous offerings in multiple markets, the Committee wishes to underscore its views that, for the foreseeable future, international offerings targeted primarily at a single national market will be far more numerous, principally due to the difficulty of coordinating significant differences in market practice which persist between the various markets. While internationalization of the capital markets may contribute over time in the reduction of these differences, their origin in the structural characterstics of particular markets (e.g., the absence of a retail distribution system in the United Kingdom) indicates that they will not disappear simply with changes in disclosure standards. Nevertheless, by facilitating international offerings (whether multiple market or single market) through the use of the reciprocal prospectus, the Commission will inevitably be aiding in the development of more similar distribution as well as disclosure practice.

While the Committee agrees with the Commission on the importance to U.S. investors of the Canadian and British markets, the Committee wishes to underscore its view that the experiment contemplated by the Concept Release should commence as soon as possible in as many markets as possible, even if this means temporary limitations on those eligible to participate. In this regard, there are three points: First, given the emergence of the Japanese market as one of the major world financial centers, the Committee would urge the expansion of the markets covered to include Japan — one of the major sources of foreign securities of a calibre and investment quality appropriate to the U.S. investor. Second, while the Committee would like eventually to see the reciprocal prospectus scheme, as outlined above, open to all issuers, in order to avoid delay, it may be appropriate that implementation of the Concept Release be limited initially to "world class" issuers. Finally, while legislation may be required in other markets before a U.S. prospectus is accceptable for use in such markets, the Committee would urge that, so long as there is a good faith effort taking place to obtain the necessary legislative changes, the U.S. should not delay opening its doors unilaterally to foreign issuers under the reciprocal prospectus approach.

In this fashion, not only will the Commission be serving the needs of the American investment community by increasing access to the world capital markets, but it will be taking the lead in the dialogue that will inevitably take place in the coming years in relation to the development of international disclosure standards.

Finally, the Committee wishes to stress that an essential element in the increasing internationalization of capital markets is an emerging concentration of activity in the three world financial centers New York, London and Tokyo. Of these, it can well be argued that London is becoming increasingly important, not only because it has been the center of the vast Euro-bond and -money markets but also because it is fast becoming an entrepot for the sale, listing and trading of non-domestic equities. For example, in 1984 there were some 60 equity-related offerings by Japanese companies through the London market and only one in New York. Also, in 1984 there were about 68 listings of foreign companies on the London Exchange compared to 20 in the U.S., of which three were on the NYSE, one on the AMEX and 17 on NASDAQ. This trend towards the London market will continue, especially in light of the London Stock Exchange's recent rule changes which increase access to the London market. Increasingly, sophisticated U.S. institutional investors are purchasing new issues of equity through the London and Tokyo markets. Meanwhile, the broad U.S. institutional and retail market cannot avail itself of these opportunities.

We believe that a key objective of Commission policy on the international front should be to permit as level a playing field as possible among these three centers, recognizing there will be differences in national requirements, so that decisions by investors and issuers as to which market to choose will be based on economic factors rather than regulatory difference. Thus, we believe that the Concept Release represents a major step in focusing attention on the need for action: action which we firmly believe should take the form of the reciprocal approach.

Again, the Committee applauds the Commission and Staff inititive in issuing the Concept Release. The Committee is willing to assist the Commission and the Staff in taking the necessary action to make the reciprocal prospectus concept reality in the near future.

Sincerely,

Robert Roosa

cc: John Huber

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM CHARLES N.VILLIERS

Q.1. Looking at the historical safety of the Euromarkets, does it make sense generally to have different regulatory procedures for transactions among sophisticated institutions as opposed to transactions involving individuals and smaller institutions?

A-1 It is clearly appropriate that the regulatory regime applying to the international professional markets should recognise their character and the nature of the relationships between participants. It would be inappropriate to seek to impose regulations of a kind intended for the protection of small retail investors. The proposed UK regulatory structure, in which functionally based self-regulatory organisations (SROs) play a major part, should help to ensure that the rules suit the markets to which they apply.

The International Securities Regulatory Organisation (ISRO), which has been formed with the intention of becoming the SRO for London-based participants in the Euromarkets, is currently seeking the agreement of the Government to the inclusion, in the Financial Services Bill, of specific provisions relating to professional investors. These would require that regulatory authorities, when making rules or regulations, should have regard to the fact that professional investors require a lesser degree of protection than others; and to the need to maintain the efficiency and competitiveness of the London markets.

Q.2. Do you support the eventual development of a common regulatory or disclosure system for participants in international capital markets?

A-2 As regards primary issues, common standards of disclosure are clearly desirable in principle. The efforts at harmonisation made by the European Community are not encouraging however; the Listing Directives are sometimes obscure and ambiguous and give rise to practical difficulties in implementation. The cumbersome process of agreeing common standards also means that it is difficult to secure changes to accommodate developments in the markets.

In the secondary markets, no one could oppose the principle of seeking a common standard of good practice; but it is questionable whether attempts to establish a common system would achieve the desired aim, or merely impose new bureaucracies. In practice investors will seek to deal in markets where they are assured of transparency and fair dealing, and this will tend to encourage the adoption of equivalent standards, without formal adoption of common requirements.

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GARN--VILLIERS

Q.3. It has been suggested that the Euromarkets are largely "unregulated", yet testimony at the hearing indicated that, in fact, certain types of regulation do apply. Are Euromarket issues ever listed on exchanges, and if so, do they become subject to the regulations of either those exchanges or of the countries in which the exchanges are located? Please describe the regulatory requirements that are imposed at each stage of Euromarket underwriting and trading, and how these requirements are different from those applying to domestic bond issues.

A-3 Many euromarket issues are listed on stock exchanges, including the London Stock Exchange. This is mainly to satisfy the requirements of institutional investors who are commonly subject to limitations on the proportion of their portfolios which may be invested in unlisted securities. In order to obtain listing the normal requirements of the exchange have to be met. In London and on certain other exchanges, however, the listing requirements for euromarket issues are more flexible than those applying to domestic issues. The exchange is not usually the focus for trading of the securities after listing, and the exchange's trading rules are therefore of little relevance.

In the United Kingdom the law relating to the issue and trading of securities is about to be reformed by the Financial Services Bill now before Parliament. Briefly, under the present system, euromarket issues are in principle subject to the Companies Act and Prevention of Fraud (Investments) Act (PFIA), in the same way as domestic securities. For new issues, certain specific exemption provisions under the present legislation permit a very flexible regime. The secondary market is governed by the PFIA. Dealers in securities have to be either licensed by the Department of Trade, in which case they are subject to Licensed Dealers Rules laying down certain standards for the conduct of business; or they may be exempted, most commonly by virtue of being a recognised bank. This regulatory regime for the secondary markets is not rigorous either in its requirements or in enforcement. The prevalence of fair dealing in the euromarkets is mainly due to competitive pressure and the expertise and vigilance of the participants.

Under the new regime to be introduced by the Financial Services Bill, all investment businesses will require to be authorised either by the Securities and Investments Board (SIB) or by a recognised Self-Regulatory Organisation (SRO). Authorised businesses will be subject to Conduct of Business Rules. All new issues of securities will be subject to listing or prospectus requirements, but there is provision for different requirements in different cases. The precise terms of the regime which will apply to the euromarkets are not yet known, but the Government are aware of the dangers of over-regulation and have made it clear that they wish to maintain the speed, flexibility and efficiency of the markets.

Q.4. Given the difference in regulation between the U.S. markets and Euromarkets, have there been any significant differences in the number of failures or near failures of financial institutions?

A-4 I doubt whether an accurate statistical answer could be given on this point, given national differences in the classification of financial institutions; the complex corporate links between UK-based Euromarket houses and overseas affiliates or parents, which in many cases support the capital of the London entity; and the fact that "near failures" must be mainly a matter of hearsay. It is my strong impression, however, that the record of the euromarkets in this respect is very good.

Q.5. What will be the effect of the new Securities Investment Board being established in the United Kingdom to oversee securities activities? According to the testimony, the role this board will play will be similar but not identical to the role played by the Securities and Exchange Commission in the United States. In designing this board, which SEC programs and systems were adopted, and which were rejected? Why?

A-5 The Financial Services Bill, which will create the powers to be given to SIB, is still before Parliament. The precise character of SIB - whether a statutory body or a private one - and the extent of its powers, particularly with regard to investigation and prosecution, have been matters of controversy and are still unresolved. SIB itself is still at an early stage in drafting its rules for the conduct of investment businesses. Until these processes are complete, the probable effect of SIB on the London markets cannot be judged. SIB is known to have studied SEC rules and practices, but it is too early to say how much will be adopted and how much rejected.

Q.6. What is the United Kingdom's regulatory approach for dealing with the potential conflicts of interest involved with banks underwriting securities, which include the following (see Investment Co. Institute v. Camp), 401 U.S.C. 617 (1971)):

- the possibility that a commercial bank might make unsound loans to companies in whose securities the bank has invested or become otherwise involved;
- the possiblity that commercial banks might use their reputations for financial prudence and restraint to convince customers to purchase particular stocks or securities, only to have that reputation undermined by the risks inherent in securities investments;
- the possiblity that a commercial bank would encourage customers to borrow money from the bank to purchase securities promoted by the bank, thereby increasing speculative investment;
- the possibility that the trust department of a bank would purchase securities for the trusts from the bank, even when other securities represented better and/or safer investment; and
- in sum, the possibility that the promotional incentives and pecuniary stake in the success of particular investments might prevent disinterested commercial banking and adversely affect public confidence in the commercial banking system.

Has the United Kingdom's approach to regulating these potential conflicts been successful?

A-6 The United Kingdom has never legislated to divorce banking from the underwriting of securities. The two activities have been routinely undertaken together by merchant banks in London. Banks have however been excluded from distribution (as opposed to underwriting) of domestic securities, not by law, but by historical accident - the development of the rules of The Stock Exchange. That exclusion is about to come to an end. In the Euromarkets, banks have for some years been engaged in both underwriting and distribution.

The potential conflicts listed in your question are only some and, I would suggest, far from the most important of the conflicts which can in theory arise when different activities are undertaken within a single company or group. You may be interested in the enclosed comments on the subject of conflicts of interest, made in a speech in November 1985 by Sir Kenneth Berrill, Chairman of the SIB.

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GARN--VILLIERS

The particular conflicts which you list are not generally considered to present a significant danger. Leaving aside the ethical traditions of the banking community - which are very strong - commercial self-interest provides the strongest possible disincentive to the abuse of trust or reputation. This commercial disincentive outweighs any "promotional incentives and pecuniary stake" of the kind to which you refer.

The regulatory approach now being taken in the UK is to reinforce the natural operation of self-interest with a system of vigilant monitoring, reporting requirements and specific duties of disclosure to clients where certain types of conflict may exist. We are in a period of change, and the effectiveness of the new framework has still to be tested. On the specific question of banks and underwriting, however, past experience in London encourages the belief that the theoretical hazards which you list will not become real problems.

Q.7. In what ways do the listing standards of the London Exchanges differ from the New York and Tokyo exchanges? How can pressure to lower standards be avoided as internationalization continues?

A-7 There continue to be significant differences between the detailed listing requirements of the major international exchanges. Some are merely matters of form and presentation, but some relate to the scope or detail of disclosure. Even within the European Community, where a Directive on the admission of securities to listing was adopted in 1979, there remain differences between the requirements actually imposed by different exchanges.

Hitherto the choice of a location for listing has been driven mainly by considerations such as size of market, probable extent of local investor interest, prestige, and depth and liquidity of trading. These factors will not disappear overnight, even though the distinctions may become less important. Moreover, any downward pressure on standards from would-be issuers is likely to meet with resistance from investors, who similarly have a choice of exchanges on which to deal: the game can be played both ways. I would not, therefore, expect pressure on standards to become a major problem, although the possibility of a reduction in standards is clearly one to which regulators should be alert.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM CHARLES N. VILLIERS

Q.1. In a number of the prepared statements submitted for this hearing, the point is made that currency volatility has led bankers and financial officers to find new financial instruments and techniques to hedge against that volatility. It could also be agreed that the very size of cross-border transactions, including hedging and currency swap transactions, increases the prospects for currency volatility. What do you see as the determinants of exchange rate volatility? It is likely to be a frequent feature of a growing international capital market? Is a stable, low inflation, macroeconomic policy environment in the major Western economies the prescription for exchange rate stability?

A-1 The form of exchange rate volatility is dependent on the policies pursued by governments. If governments operate a pegged exchange rate system, then exchange rates remain stable for long periods and then move in sudden jumps to the new parities. If governments adopt a policy of completely free floating, then foreign exchange markets would be akin to stock markets, with considerable volatility both in the short and long-term. In an intermediate position, governments may allow the main movements in exchange rates, but attempt either to smooth out short-term changes or to take the extremes out of the cyclical fluctuations.

Transactions in the foreign exchange markets are based heavily upon expectations. People undertake transactions in order to make a profit or to safeguard themselves against potential loss, in the light of hopes or fears as to future exchange rate movements. These expectations are set partly in relation to underlying economic changes (such as say an increased trade surplus in a country) and partly in relation to what governments may do. Part of the art of exchange rate management by governments is to keep the market uncertain, so that governments retain some initiative. Thus, three main factors in determining exchange rate volatility are:-

1. The exchange rate regime operated by governments;
2. The underlying volatility of economic and financial policy; and
3. The techniques used by governments to influence the financial markets including the foreign exchange market.

Exchange rate stability requires consistence of economic policy among the countries linked in the system. It is almost impossible for such convergence to be achieved if countries are growing at varying rates or if financial conditions differ a great deal, such as in relation to inflation. Thus a stable, low inflation, macroeconomic policy environment - as was seen throughout the Bretton Woods period - is a necessary prescription for exchange rate stability.

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HEINZ--VILLIERS

Q.2. Last September, the G-5 governments met in New York and agreed on a more active policy of coordinated intervention to ensure that their currencies accurately reflected the underlying strengths of their economies and to combat speculative currency movements. Since that time, the dollar has fallen roughly 15 percent against the deutschemark and yen. Does this reflect the success of the intervention agreement or other factors? Can intervention affect the market on more than a short-term basis -- actually changing underlying currency values?

Several pieces of legislation pending before the Congress call for accumulation of reserves of foreign currency to be used in a more active U.S. intervention policy. Would this be a useful step, in your view?

A-2 The fall of the dollar since the Group of Five meeting last September reflects a variety of factors and it is difficult to be precise as to their relative weight. The initial intervention itself almost certainly had some effect on exchange rates. It was also important as an indication of the determination of goverments. Initially, other countries increased interest rates. It became clear that the Japanese government was willing to see the yen appreciate. A very important factor in the foreign exchange market is the market's view as to the yen exchange rate which the Japanese goverment is willing to accept.

As a whole, the intervention agreement and the associated measures have been successful.

Intervention as such tends to have a relatively short-lived effect on the market. But a continuing policy of intervention, associated with relevant other policies, may have a significant effect upon the trend movement of an exchange rate.

A problem of exchange rate intervention is that it is not possible for all countries to have independent policies regarding their exchange rates. Since countries interact with each other, there is usually a residual currency against which other countries set their rates. In the Bretton Woods system this was the United States dollar. Under present conditions the most likely scenario is that other countries would have dollar policies. The United States could not have a totally independent intervention policy. Accumulating some reserves of foreign currency could give the United States greater flexibility in its intervention policy in as far as it wished to act on its own at times or to act more effectively in co-ordination with other countries.

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HEINZ--VILLIERS

Q.3. The Administration talks increasingly about the idea of reform of the world monetary system, as most recently indicated in the President's State of the Union address. Presumably the goal would be greater management and stability of currencies. Do you see a need for fundamental reform of the system and what changes, if any, are needed? What benefits or problems would arise from such a change?

A-3 It is very difficult to know what is meant precisely by "reform of the world monetary system". Having exchange rates at an acceptable and appropriate level, and having greater stability of exchange rates, have become objectives of significant political importance in many countries, including now the United States. To realise this political objective would require modifying the operation of the world monetary system so as to give governments greater control over exchange rates and an ability to achieve greater stability of them.

Once one goes beyond that limited objective, it is very difficult to know how important any further changes are in political terms, and it also becomes more difficult for them to be achieved under negotiation.

The Bretton Woods system was put together in negotiations essentially between two countries, the United States and the United Kingdom, with the United States being by far the dominant partner. Bretton Woods instituted a series of disciplines, which countries were willing to accept in the interests of the system as a whole.

The problem now is that the world is far more pluralistic, with the relative economic weight of the United States in the western world much reduced. Many western countries of substantial economic and financial influence hold doctrinaire views which are opposed to those of the United States. It would be exceptionally difficult to negotiate a new international treaty under those circumstances. There is not at present any consensus as to the best way forward as a means of combining individual country interests with those of the system as a whole. It is difficult to consider what benefits or problems might arise, without knowing precisely which specific reform propositions are under consideration.

Q.4. Concerns have been expressed that the massive current account and fiscal deficits of the U.S. vis a vis the rest of the world could lead to a loss of confidence in the U.S. economy, resulting in a rapid drop in the value of the dollar and in capital inflows. Actual experience over the last year has been of gradual decline in the exchange rate and modest inflation. With the dollar declining but with uncertain prospects for fiscal deficit reductions, what do you see as the prospect for foreign capital inflows to the U.S.?

A-4 It is also difficult to know precisely how much net capital inflow is required to finance the United States current account, in view of the enormous errors in the world balance of payments figures. The means used to finance the United States balance of payments, whether a reduction in United States capital outflows or larger foreign capital inflows, is difficult to forecast since it depends upon market expectations. At present the markets have accepted a gradually weakening dollar, with the assumption that inflation will remain low, and that interest rates will, if falling, remain above those in the traditionally hard currency countries.

The issue is not whether there will be net capital inflows into the United States. It is a matter of arithmetic definition that if a country runs a current account deficit then it is financed. The issue is the form of the net capital inflow and the circumstances in which it occurs. Will it be a voluntary flow of foreign capital into a stable dollar or, for example, an increase in involuntary holdings of dollars by foreigners faced with a declining dollar? It is now very difficult to foresee future developments, but there is certainly a risk of dollar weakness, to which the United States authorities may react with higher dollar interest rates.

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HEINZ--VILLIERS

Q.5. Financial transactions have grown to be many times larger than underlying commercial transactions -- one estimate places financial transactions at 12 times world trade. What are the principal determinants of these massive financial flows? How do these flows relate to underlying trade transactions? The free flow of capital is normally viewed as beneficial, but are there ways in which it is a destabilizing influence?

A-5 A distinction needs to be drawn between financial transactions and financial flows. An organisation may make many transactions back and forth across the exchanges in accordance with changing views of future financial conditions, but the net resulting flow from these transactions may be very small. The principal determinants of financial transactions across the exchanges are expectations of likely exchange rate movements, which in turn give rise to hopes or fears of gains or losses.

Some of these transactions will be related to trade, in as far as companies will have payments receipts or payments to make in the future, and will wish to change their hedging structure in relation to expectations.

Other transactions may relate to asset positions of companies which may, for example, have long-term assets in certain jurisdictions, and may wish to hedge their balance sheets according to circumstances.

Other transactions will take place as organisations make a market in foreign exchange. Some companies treat their treasury as a profit centre, and there may well be transactions by such organisations which are unrelated either to trade or to the capital position of the company concerned.

A stock market is extremely volatile, because it is a market in which there is no outside intervention, and the market feeds on itself basing transactions to some extent on income but mainly on expectations. During the period of floating exchange rates after 1972, the foreign exchange market was left much to itself and it behaved like a stock market, feeding on its own expectations, and leading to enormous volatility of exchange rates. Such a situation may be called destabilising. Because it was very difficult for participants to forecast what would happen next, so a series of probably inconsistent responses took place and we had great volatility of inflation, monetary policy and exchange rates. Others might simply say that that was just volatility. In my view an exchange rate system needs to have some anchor in government policies if it is not to generate instability.

Q.6. Major LDC debtors have experienced serious difficulty meeting external payments due to adverse external developments (falling commodity prices, higher interest rates) and flawed domestic economic policies. The Baker initiative announced in Seoul calls for market oriented policy reforms to promote private sector growth supported by additional commercial and official lending. What do you see as necessary to restore the confidence of financial markets in the key debtors? What are their prospects for attracting investment or raising capital in international markets for the forseeable future?

A-6 The main requirement is for debtors to move their debt ratios towards creditworthiness criteria. Short of that, they would need to show steady improvements in their debt ratios, with the prospect that they would move to creditworthiness levels in the near future. Countries should pursue successfully economic policies related to stability and strength as regards both the balance of payments and domestic economic activity.

The prospects for attracting capital investment from abroad relate to general creditworthiness, and to expectations about stability and reliability of the domestic legal and governmental system. One of the main needs of many of these countries is to repatriate back the very massive amount of capital which went abroad during the 1970s and early 1980s. This repatriation of capital requires expectations of profitability in the particular country, which must relate in turn to expectations about the appropriate economic policy and to the reliability of the legal process. In many cases, such countries should take steps to improve the financial infrastructure, in relation to the efficiency of their markets for transferring savings to investment uses.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM CHARLES N. VILLIERS

Q1. It is my understanding that your Government is planning to have its Financial Services Act on the statute book by the end of 1986 and that it essentially would provide statutory backing for a comprehensive practitioner-based system of regulation for the financial services industry.

I am wondering if you would outline for us, as best you can, the basic differences between your proposed regulatory approach to the financial services industry versus that of our American regulators and our United States regulatory system. Then I would like you to tell us why you have opted for the approach you are taking?

A-1 The regulatory system now being established in the United Kingdom was outlined in a White Paper (policy paper) entitled "Financial Services in the United Kingdom" (Cmnd 9432) issued by the Secretary of State for Trade and Industry in January 1985. Chapter 3 of the White Paper included a statement of objectives and of the principles underlying the new system. It may be helpful to quote two key passages. First, one of the objectives was stated as follows:

"Flexibility - the regulatory framework must be clear enough to guide but not cramp structural and other change in the industry. It must have the resilience not to be overrun by events".

The section on principles underlying the new system contained the following statement about self-regulation.

"Self-regulation has a continuing and crucial contribution to make. It means commitment by practitioners to the maintenance of high standards as a matter of integrity and principle, not because they are imposed from outside. Regulation should encourage the commitment of individuals in the financial services industry to high standards. It is in the interests of both the industry and its customers that the opportunity for theft, fraud and deception in the buying and selling of securities and investment services should be minimised".

The United States regulatory system is commonly perceived in the United Kingdom as being legalistic and interventionist, leaving very little to be decided by "integrity and principle". In contrast it is claimed that the traditional British system of informal self-regulation emphasises respect for the spirit, as well as the letter, of codes of conduct. The government have evidently wished to preserve this virtue.

In reality, the United States and United Kingdom systems are not as far apart as is sometimes thought. I understand that the United States system does in fact involve a large element of self-regulation through, for example, the NASD and the major stock exchanges, within a statutory framework. In the United Kingdom, the tradition of informal regulation, resting on common beliefs and assumptions, was bound to come under pressure as the financial services industry expanded and new players entered the market. The new type of self-regulation now being developed still involves collective implementation of rules by practitioners, but the initiative in drafting the rules has been taken by the SIB, and the self-regulatory organisations will be required to adopt rules at least as stringent as SIB's own.

In addition, the financial markets will be subject to the full rigour of civil and criminal law. The Government have made it clear that they are committed to vigorous enforcement of the law with regard to, for example fraud and insider dealing, as an essential part of their policy towards the financial markets.

Q2. What do you see as some of the major obstacles to a truly international equities market and what steps do you think should be taken to address them and to encourage the internationalization of our markets?

A-2 Investors and traders require, first and foremost, reliable, timely and relevant information about the issuers of securities. The listing requirements of major exchanges are designed to ensure that this is provided. For professional investors, however, some of the detail (e.g. historic financial information) commonly provided in prospectuses or listing particulars is otiose, particularly where the issuer is a well-known company or international organisation. In addition, investors are helped by the availability of professional analysis and comment on possible investments, drawing attention to key features of the securities and assessing their worth and prospects. Cross-frontier comparisons, which make it possible to make global judgements on sectors and industries, are particularly valuable to major investors with an international perspective. There is room for improvement in the service provided to international investors in some of these areas. Bearing in mind the link between research services to investors and market share in brokerage transactions, I would expect these gaps to be filled by commercial initiative.

Second, international investors and traders need an effective settlement, custody and transfer system, comparable to that provided by Cedel and Euroclear for the international bond markets. Such services are already being developed in relation to international equities.

Finally, there remain artifical constraints such as taxation or exchange controls. Removal of these distortions where they exist would obviously encourage the internationalisation of markets.

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RIEGLE--VILLIERS

Q3. Many commentators believe that the deregulation of the London market may well lead to an increase in trading of world securities on the London stock exchange.

Do you believe that this will be the case and what steps are being taken to increase the number of world-class securities traded on the London Stock Exchange?

A-3 London has natural advantages as a trading centre for world securities. Its geographical position puts it approximately half way between the time zones of New York and Tokyo. It has an unrivalled infrastructure of banking and professional services, as well as an attractive quality of life. The development of the Euromarkets has shown that, given a flexible regulatory regime, London can be a major trading centre.

The rules of The Stock Exchange in London have made The Stock Exchange a relatively expensive place to trade. They have also discouraged the accumulation or introduction of capital in Stock Exchange member firms and this, together with the single capacity trading system, has meant that institutional investors have not enjoyed the facility to deal instantly in large size which has developed in, for example, New York.

These restraining factors are now being removed. The Stock Exchange are evidently keen to accommodate international equity business and have been holding discussions with international securities houses about the technical requirements for a truly international exchange. In addition, new electronic information and trading systems are being introduced, which will make it possible to retain high standards of surveillance and supervision while coping with greatly increased speed and scale of trading. I would expect that these developments, taken together, will significantly increase the extent of trading of world securities on The Stock Exchange.

Q4. To what extent, if at all, do you think the London Stock Exchange should coordinate its enforcement activities with the SEC and other regulatory agencies in other countries when it comes to the trading of world-class financial instruments?

A-4 The concept of a well defined and controllable domestic market is rapidly becoming outdated. Electronic markets can link issuers, investors and traders anywhere in the world, and it may be difficult for their activities to be effectively controlled by a stock exchange authority operating under one legal jurisdiction. Co-operation between regulatory authorities is clearly essential. This extends beyond The Stock Exchange; the Bank of England is also seeking co-ordination of enforcement activities with regulators overseas.

Q5. It is my understanding that the Japanese stature and presence in the Euromarkets has been expanding dramatically. For example, last year 8 Japanese securities houses and banks ranked among the top 50 underwriters of Eurobond issues, playing the lead role in offerings that totaled $15 billion. In 1984, by contrast, 6 Japanese firms ranked in the top 50, accounting for new Eurobond issues of $6.4 billion.

How do you account for Japan's success and increasing expansion in the Euromarkets?

A-5 The increasing success of the Japanese is due in part to their effective exploitation of the significant outward investment flows from Japan, resulting from high savings ratios, low yields on domestic debt instruments, and investors' interest in international diversification of portfolios. Japanese houses are well placed to distribute euromarket issues to Japanese investors. In addition, some Japanese houses have been willing to seek mandates from Euromarket issuers at unprofitable margins, in order to establish market share.

EXTRACTS FROM A SPEECH BY
SIR KENNETH BERRILL K.C.B.
CHAIRMAN OF THE SECURITIES AND
INVESTMENTS BOARD AT A
SEMINAR GIVEN BY
THE SOCIETY OF INVESTMENT ANALYSTS

28 November 1985

CONFLICTS OF INTEREST : THE SIB'S APPROACH

.....I should like to comment briefly on the approach that my Board is taking to the control of conflicts of interest. I am only too well aware that on this question, perhaps more than any other, the City is looking to the SIB for guidance, and that there is much uncertainty about how the SIB's requirements, let alone the common law, will bear on the recently-formed City conglomerates, many of which may deal for or with clients in a number of capacities. I hope that the SIB's conduct of business rules, as they emerge over the next few months, will help to clarify matters.

There is nothing new about conflicts of interest. Everyone in business - on the Board of a company, in a solicitor's or accountant's office - faces them all the time. Merchant banks were conglomerates, in the sense of undertaking potentially conflicting activities for clients, long before the Stock Exchange opened its doors to them and the problem of conflicts of interest became the daily bread of expensive conferences. Even single capacity stockbrokers have conflicts: for example, the interests of the firm as against the interests of the client in managing a discretionary portfolio, or balancing the conflicting interests of a corporate finance as against a dealing client. There is nothing new, either, about dual capacity in the City.

Recent financial mergers appear to have given rise to three main fears. First, that clients of broker/dealers will lose out in the conflict between their interests and those of the firm's book. Second, that corporate and institutional clients will lose confidence in firms which have a wide spread of interests in potential conflict with their own. And third, that the new conglomerates will run foul either of agency law, or of the requirements of the new Financial Services legislation, or both - and will have to establish such onerous compliance procedures that all the benefits of synergy and integration that we were talking about a year ago will be lost. This last fear has led to suggestions that the new Bill should, in some way, waive or modify agency law as it applies to financial service companies, leaving the SIB and the SROs to devise acceptable safeguards of their own in the context of their Conduct of Business Rules.

I shall return to this last point in a moment. But I think it would be helpful first to describe the general approach that the SIB and MIBOC are taking in preparing their conduct of business rules.

We start by trying to make a clear distinction in our Rules, in the expectation that investment businesses will be able to make a similarly clear distinction in their practices, between the person who is owed a fiduciary duty by a broker/dealer and the person who is not. We refer to the person to whom the firm owes such a duty as a 'client'. Whether or not a person is a client for purposes of our rules will depend on many factors, including the way in which the relationship with the firm has developed and the way in which the firm holds itself out. If he is a person who looks to the firm to provide him with a service rather than merely to deal with him as a counterparty then he is client.

A firm's relationship with its client does not change when it deals as principal on a particular occasion. If the client has been led to expect that the firm is providing him with services or acting as his agent, then that is what the firm must do. It still owes a duty to the client which cannot be switched on and off like an electric light. Professor Gower's dictum 'Once an agent, always a fiduciary' is the foundation upon which we are developing our rules.

Second, we shall attempt a clear definition of the professional investor, as a person to whom a firm may in general make rather less disclosure and who may be assumed to need rather less protection. Our intention here will be to cover other investment businesses and any person who operates sufficiently regularly by way of business in a kind of investment not to need the more stringent forms of protection. This may mean that a person may be a professional in one transaction or relationship and a private client in another. A farmer, for example, may be a professional when he sells potato futures but a private client when he buys equities; but that is unavoidable if the exemption is neither to be unduly restrictive nor to be open to abuse. The requirement for written agreements should help to clarify matters.

Both private and professional investors may or may not be clients of a firm. This means that we can distinguish in our rules four broad classes of person: the professional customer, the professional client, the private customer and the private client. Different duties are likely to be owed to each type of person. Complicated but necessary: and I believe that the clear definition of a class of professional customers ought to help to resolve some of the uncertainties that have been bothering, among others, the new gilts market-makers.

Let me now turn to the main duties that we will impose on firms. We start from basic principles that were foreshadowed in the White Paper and which we expect to be included in the Bill: for example, requirements to observe high standards of integrity and fair dealing; a duty to act with skill, care and diligence in providing services to the investor; to subordinate the firm's interests to those of the client; to have regard to the client's circumstances; and to disclose material facts and interests including the capacity in which the firm deals.

Now within the context of the distinctions that I have made between the customer on the one hand and the client on the other, these principles do not look unreasonable: indeed many are derived from the present law of agency and ought, as a matter of course, to be observed by anyone who provides services to a client. And many relate to firms only where they are acting for clients or providing services to clients. Only the basic rule of fair dealing, and the requirement to disclose material facts and interests, can be expected to have a broader application.

What our Conduct of Business Rules will do is attempt to clarify what these principles mean in practice. So far as possible we shall attempt to provide a framework in which the investor understands what to expect from the firm and the firm is in no doubt as to the duties he owes to the investor. For example, we shall be looking to firms to make clear to their customers whether they are providing them with services or dealing with them; and in many cases we shall expect there to be agreements in writing between the firm and the customer setting out the basis on which business is to be transacted between them. The agreements will cover the way in which the firm will be remunerated and the capacities in which it may act and should make clear beyond doubt the nature of the relationship with the customer or client.

We have then to deal with two basic conflicts. First, the case where the firm or its associate has a direct financial involvement in a transaction about which it is giving advice to a client or which it is proposing to effect for a client - the broker who is a market maker, for example, or who is selling cotton futures when he has a warehouse full of cotton. Second, the case where the firm is acting for another person whose interests are different from the client's - the broker who is placing a block of shares for an institution, for example, or advising a corporate issuer.

My Board has taken the view that the overriding requirement in both of these areas should be disclosure. As a general principle, we see no reason why a firm should not have an interest that conflicts with those of its client, provided it is disclosed to the client as such and the client gives his fully-informed consent to the firm having the interest while advising or dealing for him. In practice we believe that the process of disclosure and consent does not need to be over-laborious and we hope in our Rules to describe procedures which combine proper investor protection with the efficiency of the broker or dealer in acting on his behalf.

There may, of course, be some potential conflicts which do not admit a resolution in this way. The volume overriders paid by some life companies to independent intermediaries, for example, give rise to a situation where supposedly independent advice may well be biassed and where the nature of the inducement is not capable of straightforward explanation to the client. In this area - and in the area of reciprocal arrangements and inducements more generally - we may well need, exceptionally, to consider restriction or prohibition as an alternative to disclosure.

Special consideration needs also to be given to the case of the agent who wishes to deal as principal with his own client, or to execute a client order with an associate. We take the view that this should be permitted provided the client has given a prior agreement to the firm dealing with him in a principal's capacity, and that, by effecting the transaction as principal, the broker/dealer gives his client best execution - that is, the transaction is done on the best possible terms to the client, taking account of all commissions and other charges payable by the client. Both conditions must be satisfied if the firm is to deal direct with its client. So long as they are I can see no reason why the firm should not deal in this way, provided the firm discloses after the event that it has done so. And if the firm has followed this rule, there should in general be no reason why it should disclose the turn on its book or its associate's book. What it must do is disclose in advance, and obtain the customer's express or implied agreement to the basis on which it is to be remunerated. A firm may not take a turn in its capacity as agent: if it does a transaction for the client in that capacity the price it gets must be the price to the client, less any agreed commission. When acting under the best execution rule, however, the firm would be subject to an analogous restriction which would achieve the same effect.

It is important to be clear as to what our rules will not require. We are not suggesting that a firm should, when acting for a client, be under a duty to tell the client that he could get a better deal if another firm were acting for him. The client has chosen that firm for the whole range of its services. It is to be within that context, and that context alone, that the firm must give best execution. I should also say that a Best Execution rule does not, in my view, require a firm always to deal at the best apparent market price regardless of all other circumstances. What is important is that the client should get the best terms - price will be important, but other considerations such as the likelihood of prompt settlement and the suitability of the counterparty may also be relevant. Of course if challenged the agent would need to be able to defend his position.

Pure disclosure requirements are relevant in the case of the firm giving advice to a client about - or acting for a client in - a transaction in which it has a material interest, other than that of a principal or market-maker - for example, underwriting a new issue; receiving commission from a third party on sales; or being controlled by the issuer of the security in question. The requirement here must be a simple statement of the interest, made at the time advice is given and before any transaction is done, that gives the customer an opportunity to understand its relevance to the transaction that he is contemplating. Such a statement can be made orally but there must be confirmation in writing.

It is in this area that we need to consider the relevance of Chinese walls, or arrangements designed to prevent information known in one part of a firm being known to individuals elsewhere in the organisation. Many financial groups have instituted such arrangements as means of preventing conflicts between their duties to corporate finance clients on the one hand and managed clients on the other. Chinese walls can promote confidence in the integrity of a firm and the trend now is for such arrangements to be multiplied and strengthened as clients become increasingly conscious of potential conflicts. I do not wish to discourage this process. But I am not persuaded that the arrangements themselves should give rise to an exemption from disclosure requirements. What is relevant to the client and to the regulator is not that arrangements exist for preventing the flow of information within the firm, but that the information is genuinely not known to the individuals in the firm who are directly or indirectly involved in dealing with the client customer. In other words, we are interested in the results of Chinese walls, not in their existence.

In other areas, too, we shall be interested in substance rather than form. We shall, for example, not in general require firms to put specific activities into separate companies. Drawing a corporate veil around certain activities like market-making does not provide any significant protection to the investor, and we shall ensure that it does not provide any benefit, in terms of lighter regulation, to the firm either. For the purposes of our Rules a conflict will require to be disclosed whether it is in the firm or in an associated company of the firm, and the best execution requirement will not be capable of circumvention by dealing with an associate rather than by the firm itself.

In the light of these comments let me return to the City's concerns about the law of agency. I do understand these concerns, but I think I have said enough to suggest that our Rules, far from disapplying the law of agency, will in fact be making clearer and more detailed provision to help in resolving potential conflicts of interest. In no sense are we prepared - even if we were able - to undermine the protection that agency law gives to the client of an investment business. My firm intention is that our rules will do a thorough job of tackling the same concerns. If they do, it may well be that the court, in applying the principles of agency law in this field, will conclude that its requirements are not too dissimilar from those of our rules. In that case the fears that have been expressed about the implications of agency law will prove unfounded. If our rules do not make adequate provision in this area then the Courts may quite properly take a different and less welcome view.

I recognise that for some firms compliance with our rules will not be simple or easy. We are trying to make our requirements practical and to ensure that they do not cut across established methods of doing business. But at the same time we have to promote the highest possible standards of conduct, and to provide certain basic protections to clients that have in the past not always been observed. I hope that in doing so I shall have the full support of the City and of the SROs which we hope to recognise.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
MARTIN W. JACOMB

Q.1. Looking at the historical safety of the Euromarkets, does it make sense generally to have different regulatory procedures for transactions among sophisticated institutions as opposed to transactions involving individuals and smaller institutions?

A-Q1 The draft rules of the Securities & Investments Board (SIB) distinguish between "professional" and "business" investors and other investors. But it is not intended to introduce anything exactly comparable to the American concept of a "sophisticated" investor based on his or her wealth. The view is that a lesser degree of regulation when the investors are "professional" will suffice to enable the Euromarkets to function without undue restraint. The Board has provisionally defined professionals as all investment businesses, persons exempted from authorisation by the Bill, and non-investment businesses, which may be individuals, who are entering into an 'investment' transaction in the course of their normal business. Thus, an authorised business selling shares to another authorised share dealer is dealing with a professional; equally, if the first business is dealing with a member of a recognised professional body in the course of his normal business, he is dealing with a professional. If a futures dealer trades cocoa futures with a chocolate manufacturer or potato futures with a potato farmer, he is also dealing with professionals, as is a bank selling an over the counter foreign currency option to an international trading company. But a futures trader who offers copper futures to a chocolate manufacturer or to a potato farmer is not dealing with a professional, nor is a bank which offers a dollar option to a corner tobacconist. At the same time, it is intended to subject markets, which formerly have been virtually free from any regulation, to sufficient control to protect private investors.

Q.2. Do you support the eventual development of a common regulatory or disclosure system for participants in international capital markets?

A-Q2 Harmonisation of regulatory and disclosure requirements in the major international financial centres is highly desirable in order to ensure that businesses are able to compete on level terms regardless of their country of origin. Currently, Japanese banks, for example, have a competitive edge over banks from the UK and US because of Japan's less onerous capital requirements. The increasing overlapping of banking and securities business makes it increasingly important that businesses are subject to a common system of supervision, not only across countries but also across different groups of institutions within countries.

Harmonisation of disclosure will also become increasingly important in combatting financial market malpractice, which will become increasingly cross-border in character.

GARN 2

Q.3. It has been suggested that the Euromarkets are largely "unregulated", yet testimony at the hearing indicated that, in fact, certain types of regulation do apply. Are Euromarket issues ever listed on exchanges, and if so, do they become subject to the regulations of either those exchanges or of the countries in which the exchanges are located? Please describe the regulatory requirements that are imposed at each stage of Euromarket underwriting and trading, and how these requirements are different from those applying to domestic bond issues.

A-Q3 There are no overriding governmental regulations in the Eurobond Market. In some currency sectors, however, central banks and other bodies do impose certain restrictions, relating to such matters as the timing of issues and the nationality of lead managers. These restrictions exist in such euro-currencies as Sterling, French Francs, Deutschemarks and Yen. As markets worldwide become more and more liberalised these restrictions are becoming even fewer.

Most Eurobond houses are members of the "International Primary Markets Association". This body sets out recommendations that attempt to standardise the way in which new issues are launched, encouraging common standards and greater disclosure. Topics covered include payments of commission and deductions, stabilisation, and disclosure requirements to be given over the telephone and in the invitation telex containing the terms and conditions of the Notes.

Most Eurobonds are listed on a European Stock Exchange, usually London or Luxembourg, and the Exchange will require the issuer to comply with its listing requirements. In the case of London Stock Exchange, special rules apply to euro-currency securities which are less stringent than for domestic debt since eurobonds are traded off-market rather than on The Stock Exchange and they are normally bought and traded in by a limited number of investors who are particularly knowledgeable in investment matters. Section 7 of the "Yellow Book" (which governs the admission of securities to listing) provides for considerable simplification in the case of eurobonds both in respect of the application procedures and the required contents of the listing particulars. Luxembourg Stock Exchange requirements are no more onerous than London.

Further regulations take the form of domestic legislation in a number of countries, notably Japan and the United States, which prevent the original distribution of bonds to residents, and Britain, which restricts the advertising of issues to the public at large.

Market practice as regards secondary trading is based on rules and recommendations set out by the Association of International Bond Dealers. These rules do not have the force of law behind them and are not even binding self-regulatory rules, but are followed by dealers as good practice and include such matters as the content of contract notes, accrued interest calculations, and settlement and delivery procedures. These rules are therefore in a transition stage and are increasingly looking like binding rules, but are not there yet.

GARN 3

Q.4. Given the difference in regulation between the U.S. markets and Euromarkets, have there been any significant differences in the number of failures or near failures of financial institutions?

A-Q4 Reliable information on failures or near failures of financial institutions is very hard to obtain. We have been unable to find any comparative studies of failures in the US markets and euromarkets. You will be familiar with the figures on bank failures in the United States. Although the numbers of failures superficially seems high from a UK perspective, this largely reflects the different characters of the US and UK banking systems: most of the banking failures in the US are of small banks, which are more closely analogous to licensed deposit-takers than fully-fledged banks in the UK. In the UK, a steady trickle of licensed deposit-takers have had their licences withdrawn.

The fact that the euromarkets are professionally-based has provided an inbuilt safeguard against failure in what has been a relatively unregulated market. Failures have therefore been rare, the main examples being Herstatt in the early 1970s (the collapse of which was related to foreign currency business) and Banco Ambrosiano (which collapsed due to fraud). As far as we are aware, there have been no failures related to eurobond business. In contrast, there have been significant failures in the US bond markets in recent years, notably Drysdale and ESM. However, whilst the US system permits the failure of individual institutions, these instances and the absence of significant domino casualties demonstrated the robustness of the system as a whole.

Q.5. What will be the effect of the new Securities Investment Board being established in the United Kingdom to oversee securities activities? According to the testimony, the role this board will play will be similar but not identical to the role played by the Securities and Exchange Commission in the United States. In designing this board, which SEC programs and systems were adopted, and which were rejected? Why?

A-Q5 This has been largely answered in relation to the first of Senator Riegle's questions. We have borrowed far more from the SEC than we have rejected and SIB is continuing to do so as it drafts its rules. In general, the USA is recognised as the model to be followed with appropriate local variations.

GARN 4

Q.6. What is the United Kingdom's regulatory approach for dealing with the potential conflicts of interest involved with banks underwriting securities, which include the following (see Investment Co. Institute v. Camp), 401 U.S.C. 617 (1971)):

- the possibility that a commercial bank might make unsound loans to companies in whose securities the bank has invested or become otherwise involved;
- the possiblity that commercial banks might use their reputations for financial prudence and restraint to convince customers to purchase particular stocks or securities, only to have that reputation undermined by the risks inherent in securities investments;
- the possiblity that a commercial bank would encourage customers to borrow money from the bank to purchase securities promoted by the bank, thereby increasing speculative investment;
- the possibility that the trust department of a bank would purchase securities for the trusts from the bank, even when other securities represented better and/or safer investment; and
- in sum, the possibility that the promotional incentives and pecuniary stake in the success of particular investments might prevent disinterested commercial banking and adversely affect public confidence in the commercial banking system.

Has the United Kingdom's approach to regulating these potential conflicts been successful?

A-Q6 Although the potential conflicts of interest involved in banks underwriting securities have been the subject of extensive public debate in the approach to "Big Bang" in the UK, this is not a new situation for UK financial institutions. The principal UK commercial banks already have large investment management divisions and are experienced in the barriers which have to be maintained in decision-making and the limitations which have to be observed in the flow of information between different arms of their activities. The absence of major scandals in this respect testifies to the success of the UK self-regulatory approach in avoiding the potential conflicts.

Although the type of conflict of interest involved in banks taking controlling interest in securities houses is already familiar, it may be argued that the scale of the problem will increase as a result of the realignments of financial institutions ahead of "Big Bang". However, this is being countered by the strengthening of the self-regulatory structure provided by the establishment of the Securities and Investments Board and by the network of Self Regulatory Organisations (SROs) operating under its overall direction. As with the US system, the key to the proposed UK regulatory system will be disclosure, on the basis that full disclosure of the facts of any conflicts of interest provides the best possible basis for prevention of abuses.

GARN 5

In addition, whereas there may be some increase in the scope for abuse, the increased competition resulting from "Big Bang" will, in itself, represent a limiting factor on sustained abuse. Any abuse of the links between underwriting, trading and fund management will ultimately involve a cost for final customers, whether investors or issuers. Increased competition at both ends of the intermediation process will make it difficult to exploit such situations for long.

Q.7. In what ways do the listing standards of the London Exchanges differ from the New York and Tokyo exchanges? How can pressure to lower standards be avoided as internationalization continues?

A- Q7 A comparison of the listing requirements for foreign equity in the London, New York and Tokyo stock exchanges is attached. In general it is accepted that the requirements for Tokyo are less stringent than those of New York and London. The disclosure requirements for price sensitive information are also more rigorous in London and New York. Not only is the letter of the disclosure requirements less severe in Tokyo, but it is also generally acceptd that, in practice, the Tokyo Stock Exchange's requirements are applied more flexibly.

Far from internationalisation providing pressure for lower standards, our experience supports the opposite: clients prefer to deal on exchanges with the highest standards.

Q.8. You stated in your testimony that the Euromarket is "restricted by commercial pressures to first class participants." Because of developments in technology and investor sophistication, are these markets likely to expand in the future to include institutions now classified as smaller and less well-known?

A- Q8 Technological developments, particularly as they affect the provision of information and the operation of settlements systems will keep costs of entry low. Together with increasing volume, this will enable smaller and less well-known institutions to become involved in the euromarkets as traders and underwriters.

The range of issuers can also be expected to widen. The eurobond market has typically been limited to issuers with a debt rating of at least BBB. However, one effect of the securitisation of international financial markets has been to produce an increasing involvement as investors by commercial banks. Given their relatively sophisticated procedures for credit assessment, they are more likely to accept poor credit risks (in exchange for higher spreads) than the more traditional investor base of the euromarkets has been, thereby widening the range of issuers which may be able to tap the markets.

GARN 6

A COMPARISON OF THE REQUIREMENTS AND PROCEDURES FOR THE LISTING OF FOREIGN EQUITY ON THE NEW YORK, LONDON AND TOKYO STOCK EXCHANGES

	New York Stock Exchange (NYSE)	London Stock Exchange (LSE)	Tokyo Stock Exchange (TSE)
Minimum Criteria	Worldwide net tangible assets - $100 mn	Market value of securities to be listed - £500,000	Shareholders Equity - ¥10bn
	Cumulative pre-tax income for latest 3 yrs - $100 mn	Number of public shareholders - 250	Pre-tax income for each of the preceeding 3 yrs - ¥2bn
	Minimum pre tax income for any of the last 3 yrs - $25 mn	Number of publicly held shares - 25% of issued capital	Dividend to have been paid for each of the preceeding 3 yrs
	Number of worldwide public holders of 100 or more shares - 5,000		Number of public shareholders in Japan - 100
	Number of worldwide publicly held shares - 2.5 mn		Proof of share liquidity in home market
Normal Form of Securities	Registered	Registered	Registered
Competent Authorities Governing Listing	NYSE-under the Securities and Exchange Act of 1934	The Council of the Stock Exchange	The Japanese Ministry of Finance (MOF)
Information Required for Preliminary Eligibility Review	Charters and By-laws; Specimens of Certificates; independently audited Consolidated Accounts for the previous 3 yrs; latest prospectuses; Stock Distribution Schedule; details of Large Shareholders; details of Principal Officers; effect of Domestic Tax, Accountancy and Foreign Exchange Laws on the company.	NONE	NONE

GARN 7	New York Stock Exchange (NYSE)	London Stock Exchange (LSE)	Tokyo Stock Exchange (TS
Formal Listing Application	Details of:	Submitted Documents:	Details of:
	Applicant company and the securities to be offered	Application form signed by sponsoring broker and the company	Applicant company and it business
	Use of proceeds	Draft prospectus	Description of stock to issued and past issues
	Recent corporate developments	Draft documents of title	Share ownerships and geographical distributio
	Directors' authorisation for issuance	Draft copies of memorandum and articles of incorporation	History of company
	History and business of company	Accountants report of previous 5 yrs	Capital stock
	Description of property, plant and equipment	Biographies of companys' directors and their business records	Employee relations
			Certified 5 yr financial statements
	Affiliated companies and ownership thereof	Board of directors' authorisation for issuance	Subsidiaries
	Principal shareholders	Certified copies of all documents referred to in the prospectus	Directors' biographies
	Stock distribution		Industrial trends
	Biographies of management and principal officers		Company's prospects
	Funded Debt		Pending litigation
	Common stock provisions		Recent mergers and acquisitions
	Employees, labour relations and unions		Supporting Documents:
	Relations with shareholders		Board of Directors' resolution of Issuance
	Dividend record		Articles of Incorporatio
	Options, warrants, and conversion rights of outstanding issues		
	Pending litigation		
	Consolidated financial statements for the last 3 yrs		
	Counsel's opinions		
	Supporting Documents:		

New York Stock Exchange (NYSE)	London Stock Exchange (LSE)	Tokyo Stock Exchange (TSE)
Board of Directors Resolution to List		
Charters and By-laws		
Certificate of controlling authorities' permission to list		
Financial statements		
Prospectuses and specimens of certificates to be listed		
Listing Agreement		

Source: Fédération Internationale des Bourses de Valeurs

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM MARTIN W. JACOMB

Q1. It is my understanding that your Government is planning to have its Financial Services Act on the statute book by the end of 1986 and that it essentially would provide statutory backing for a comprehensive practitioner-based system of regulation for the financial services industry.

I am wondering if you would outline for us, as best you can, the basic differences between your proposed regulatory approach to the financial services industry versus that of our American regulators and our United States regulatory system. Then I would like you to tell us why you have opted for the approach you are taking?

A- Q1 The basic differences between our proposed system and that in the USA are:

(a) Instead of the regulatory powers being conferred directly by the statute on a statutory Commission they are conferred on the Secretary of State for Trade and Industry who is expressly authorised by the statute to transfer virtually all of them to a designated agency or agencies if it or they meet specified criteria. In practice he will delegate them to one such agency - the Securities and Investments Board (SIB) - which has been set up specifically for this purpose as an incorporated company, the members of which are appointed and removable by the Secretary of State and the Governor of the Bank of England acting jointly. It is a practitioner-based body but with lay and consumer members and, essentially, is similar in its aims and objects to the SEC or, say, the Ontario Securities Commission.

(b) SIB will be entitled under the Act to recognise self-regulatory agencies (SROs) as long as they too meet prescribed criteria. Every firm carrying on investment business will have to be "authorised" either through direct registration with SIB or through membership of a recognised SRO and will be subject to the provisions of the Act, to the regulations carrying criminal penalties made by the Secretary of State under the Act, and to the rules and regulations of SIB (if directly registered) or to those of the SRO (if authorised through membership of an SRO). It is hoped that the number of firms directly registered will be few and that most will be authorised through SROs (of which there are likely to be five) which will undertake day-to-day supervision under the surveillance of SIB. The rules of the SROs must afford protection to investors at least equivalent to those of SIB.

(c) We also draw a distinction between "recognised SROs" and "recognised investment exchanges". The Stock Exchange will be both one of the five recognised SROs - so that its member firms will be authorised for investment business - and a recognised investment exchange. The other UK exchanges (LIFFE and the Commodities Exchanges) are likely only to be recognised exchanges on which authorised businesses will be able to operate with fewer restrictions than those applying to off-market deals. The intention is to designate certain overseas Exchanges to which the same will apply.

(d) SIB will be self-financed by fees etc, levied on the financial services industry. In addition to the fact that there will be no drain on public funds, this will enable it to recruit expert staff by offering City salaries rather than Whitehall ones (there is a growing gap between them).

(e) SIB's jurisdiction differs somewhat from that of the SEC. In some respects it is wider; eg, futures and life-assurance are "investment business" which it regulates, thus it is hoped, avoiding conflicts of jurisdiction with another agency such as the CFTC and disagreements about when and to what extent life policies are "securities". In other respects it is narrower, eg, listed public issues remain the remit of The Stock Exchange as the "competent authority" under the EEC directors, and the Panel on Take-overs and Mergers will initially retain its independent role - though it is doubtful how long that will be so.

The principal theme underlying the differences between the US and proposed UK regulatory systems is the desire to give as much weight as possible - through the SROs - to the self-regulatory approach, which has historically dominated the UK financial sector.

Q2. What do you see as some of the major obstacles to a truly international equities market and what steps do you think should be taken to address them and to encourage the internationalization of our markets?

A- Q2 Obstacles to the development of an international equities market include the lack of:

- an international clearing system;
- international harmonisation of settlement procedures, regulatory systems, reporting standards and tax treatment;
- efficient and reliable provision of price information on a 24-hour basis.

Development of an international equities market would therefore be encouraged by:

i) development of international clearing systems. The UK Stock Exchange is approaching this problem by the formation of bilateral links between its Talisman clearing system and clearing systems in other countries. At the same time, both Eurobond clearing systems - Euroclear and Cedel - have been expanding their coverage to provide clearance facilities for some European equities. This represents a more international approach to clearing than does Talisman but so far covers a much smaller number of equities. Integration of the different approaches would appear to be desirable;

ii) standardising of settlements procedures;

iii) harmonising the tax treatment of trading in equities in different centres. The growth of the ADR market in New York largely represented a means of avoiding UK stamp duty on transactions in UK equities. The dislocation to this market following the Chancellor's Budget announcement of a tax on the creation of ADRs can only have hindered the development of international trading in UK equities;

iv) the movement to more international trading in equities will transform the market from a trading floor-based market to a telephone market. It is important that this is regulated as effectively as the existing stock exchange and that the regulatory systems and reporting requirements under which they operate are harmonised internationally. Otherwise, regulatory and reporting requirements could distort decisions about the location of business;

v) the transition to a telephone market would be aided by the development of systems for the efficient and accurate co-ordination and transmission of price information. This is not a pre-requisite for rapid development of a telephone market - witness the rapid development of the eurobond market despite the widely acknowledged poor quality of price data. However, availability of good quality public price information is clearly a more important factor in equity markets, where practitioners are accustomed to the more highly visible prices available on exchanges based on trading floors.

Q3. Many commentators believe that the deregulation of the London market may well lead to an increase in trading of world securities on the London stock exchange.

Do you believe that this will be the case and what steps are being taken to increase the number of world-class securities traded on the London Stock Exchange?

A- Q3 Yes, I do believe that deregulation of the London market will lead to increased trading of world securities on the London Stock Exchange. I leave it to Mr. Knight to elaborate on the steps being taken to increase the number of world-class securities traded on the London Stock Exchange.

Q4. To what extent, if at all, do you think the London Stock Exchange should coordinate its enforcement activities with the SEC and other regulatory agencies in other countries when it comes to the trading of world-class financial instruments?

A- Q4 International co-ordination of enforcement activities is desirable and the more the London Stock Exchange, the SIB and the SEC can work towards this the better. This will become increasingly important as an inevitable consequence of internationalisation of the markets will be that there will be increasing cross-border opportunities for insider trading and other forms of malpractice.

Q5. It is my understanding that the Japanese stature and presence in the Euromarkets has been expanding dramatically. For example, last year 8 Japanese securities houses and banks ranked among the top 50 underwriters of Eurobond issues, playing the lead role in offerings that totaled $15 billion. In 1984, by contrast, 6 Japanese firms ranked in the top 50, accounting for new Eurobond issues of $6.4 billion.

How do you account for Japan's success and increasing expansion in the Euromarkets?

A- Q5 Japan's success and increasing expansion in the Euromarkets is firstly a reflection of the more general success of the Japanese economy. In particular, the substantial outflow of funds on capital account, which has been the counterpart to Japan's massive current account surplus (over $100 million over the past three years), has involved the acquisition by Japanese investors of substantial volumes of non-Japanese financial assets. In addition, the belief in the long-term appreciation of the Yen has encouraged Japanese entities to acquire non-Yen liabilities.

Secondly, the less onerous capital requirements imposed by the Japanese authorities have enabled the Japanese banks to operate on relatively narrow margins. For example, holdings of publicly issued international bonds attract a capital weighting of 0.3 in Japan compared with 1.0 in the UK and US. The capability to operate on narrow margins in international markets provded by the low capital weighting applied by the Japanese authorities is reinforced by their highly profitable domestic retail base, which has been much less open to foreign competition than has been the case in the United States, the United Kingdom and most of Europe.

THE INTERNATIONALIZATION OF CAPITAL MARKETS

THURSDAY, FEBRUARY 27, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD–538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today the Committee on Banking, Housing, and Urban Affairs continues with the second of 2 days of oversight hearings on the internationalization of capital markets.

Today's hearing consists of two panels. The first includes two chief financial officers of U.S. companies who will testify concerning their companies' participation in international markets to raise capital. They will discuss the use of commercial loans and debt and equity financing as well as the listing of company stock on foreign exchanges and the investment of funds abroad. Peter Houchin, the chief financial officer from Pepsico, Inc., was also scheduled to testify on this panel but was called away to Europe on business at the last moment. He has agreed to submit a statement for the record and to respond to written questions from the committee.

The second panel includes three witnesses who will address the internationalization of the mortgage finance market. They will discuss the increased issuing and trading of mortgage-backed securities in international markets as well as direct investing by highly creditworthy investors in other countries for real estate projects in the United States.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I'm going to ask permission to submit my statement for the record as if read in its entirety and again commend you for undertaking these hearings.

I had hoped that I would have an opportunity to hear a former alumnus of my local high school, John Hopkins, who is the managing director of Merrill Lynch, testify on the second panel. Unfortunately, the press of committee hearings will make it impossible for me to be here.

But again, let me commend you, Mr. Chairman, for these hearings and tell my friend, John, that I'm certainly going to read his testimony with great interest.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

This hearing is the committee's second during which we will address the growth of international capital markets. Yesterday the committee focused upon the ability of U.S. institutions to participate in these markets and the regulatory systems that are designed to ensure the integrity of these markets.

Yesterday's hearing demonstrated that due to the attendant economic benefits of investment transactions to the major world capital markets, the race is on in each country to make its investment environment the most attractive to potential investors.

U.S. policymakers need to act on two distinct but interrelated issues. First is the need to make the U.S. market attractive to international trading in securities. Second is the international need to develop an efficient, competitive, and adequately regulated international securities market. Ensuring a regulatory framework that provides the basic principles of investor protection, fair trading, and the disclosure of essential information should be the committee's concern.

This morning we will entertain the testimony of several of the beneficiaries of the increased access to funds that the international capital markets provide. Ease of access to the international capital markets can provide borrowers with a cheaper source of funds by promoting competition between international lenders. The use of the international markets has been greatly facilitated by technological advances in communications systems and through the ingenuity of investment and commercial bankers.

While the growth of the international capital markets has been provident for some, it has generated substantial risks. The integration of world financial systems makes our domestic financial system more susceptible to the adverse effects of a foreign financial failure. I am not saying that the growth of the international capital markets, especially the international securities markets, should be discouraged. I am suggesting that we enter into these markets with our eyes open and cognizant of the risks inherent in an increasingly international financial marketplace.

I have urged the SEC and other appropriate Federal regulators to examine the potential impact the growth of the international capital markets will have on our domestic financial markets. In order to preserve the safety and soundness of our financial institutions, some of which have been placed in a precarious position due to their international lending practices, the Congress and Federal regulators must examine existing regulatory systems to determine if they provide adequate safeguards in a rapidly expanding and complex marketplace.

We should dedicate ourselves to this task because it became apparent during yesterday's testimony that, due to the disparities that exist between U.S. and European regulation of financial systems and trading markets, investor protection varies greatly between foreign and domestic marketplaces that may be trading in essentially the same securities or debt instruments. While uniformity in trading and regulatory practices may be an admirable goal, the investor protections accorded those who invest in the U.S. capital markets need not necessarily be sacrificed in order to attain it.

This hearing and those which may follow represent the initial steps that must be taken to ensure that U.S. capital markets, lenders, issuers and stock exchanges remain competitive in the international marketplace. I look forward to the testimony of this morning's witnesses and any suggestions they may have in this area.

The CHAIRMAN. Senator Mattingly.

STATEMENT OF SENATOR MACK MATTINGLY

Senator MATTINGLY. Thank you, Mr. Chairman. I think we would all agree that the issue at hand is a fascinating though complex one. Most of yesterday's witnesses pointed out that the internationalization of capital markets is a trend that ought not to be ignored and, in fact, ought to be facilitated from the U.S. point of view. While I am excited about the possibilities of such a trend, I feel we must make sure that the U.S. role, both actual and potential, is thoroughly understood. I think that it is important to realize that this is not simply a banking financial issue, but one that has implications for the entire international economic community. Mr. Chairman I would be very interested on hearing today's witnesses' comments on transborder data flows. Both yesterday's and today's witnesses have discussed the importance of international communications to this trend. I am aware of the concerns expressed in the past by U.S. companies operating overseas as to the importance of being able to maintain confidential transfer of financial and other data. I see this a vital link in the system and feel it appropriate that we address it in the context of these hearings. Thank you Mr. Chairman.

The CHAIRMAN. Senator Gorton.

Senator GORTON. No opening statement.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No statement.

The CHAIRMAN. Mr. Blakely, would you like to proceed, please?

STATEMENT OF ROBERT T. BLAKELY, SENIOR VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, TENNECO, INC.

Mr. BLAKELY. Mr. Chairman, Senators, members of the committee staff, it is a distinct pleasure to have the opportunity to testify before the Senate Banking Committee this morning on the internationalization of the capital markets.

From my perspective as chief financial officer of Tenneco, one of the largest industrial corporations in the United States, my financing decisions are already premised on one worldwide capital market. Some years ago we crossed that bridge, so to speak, and for better or worse, I do not believe there will be an easy turning back.

Today we use the worldwide capital market and, quite frankly, would have great difficult without continuous access to them. I would ask the committee to be patient for a minute while I briefly describe Tenneco. It is integral to understanding why the international capital markets have been so important.

OVERVIEW OF TENNECO

In 1984 Tenneco was ranked 19th in the Fortune 500 on revenues and net income and 15th on assets. In 1985 our revenues were $15.3 billion, our assets were $20.4 billion, and our net income was over $400 million.

We are a large diversified energy company and about 80 percent of our income comes from energy. I believe, however, we are uniquely successful in our diversification program in part because we started much earlier than many other energy companies.

Geographically, about 80 percent of our revenues and about 86 percent of our operating income come from the United States. I will begin by stating that the capital markets are necessary and critical to Tenneco. I would wish to emphasize that that's not to finance our international operations but rather our operations in the United States.

Tenneco is the youngest among the top 20 in the Fortune 500. We were founded in 1943 as a natural gas pipeline company to move natural gas from the gas-prone areas in the Southwest to the energy markets in the Northeast. In 1950 we began an ambitious diversification program; first into oil and gas exploration and refining, and then in the 1960's, the trend expanded rather dramatically—automotive parts with the brand names of Walker and Monroe, forest products with Packaging Corp. of America, agricultural and construction equipment with Case and later International Harvester, and shipbuilding with Newport News Shipbuilding Co.

The remaining thrust of our diversification was in the 1970's with the acquisition of two insurance companies, Philadelphia Life and Southwestern Life Insurance Co. Despite this diversification from 1955–85, our pipeline assets grew by a factor of four to $2 billion, but during that same period our diversified assets grew two hundredfold to almost $15 billion.

This ambitious acquisition program has allowed Tenneco to meet its growth objectives but I must tell you candidly it would not have been possible without an ambitious borrowing program.

I'd like to focus on our borrowing program for the last 10 years. As you can appreciate, there's been a major opportunity over that period in oil and gas as well as an opportunity for us to round out our businesses. I think a number of statistics that relate to our borrowings will set this in perspective.

From 1975–85, our total consolidated debt went from $2.8 to $7 billion for an increase of 250 percent. Our corporate bank credit facilities went from $620 million to $3.2 billion, an increase of 516 percent.

Now I'd like to turn to our bank credit facilities and discuss how they're sourced. In 1975, of the total of $620 million, $75 million came from foreign banks, 12 percent. In 1985, of a total of $3.2 billion, about $1 billion or one-third was provided by foreign banks.

In addition, Tenneco has four finance companies, two in the United States, one in Canada, and one in the United Kingdom, that finance our agricultural and construction equipment receivables. These four finance companies have an additional $2.3 billion of bank credit facilities, of which 54 percent are sourced from foreign banks.

If we add the consolidated bank facilities and our finance company facilities, the total is $5.5 billion of which 40 percent is provided from foreign sources.

So the committee will have a better appreciation of which countries are involved, Canadian banks provided 14 percent, British banks and French banks each 6 percent, German banks 5 percent, Swiss and Japanese banks each 2 percent.

I draw a number of conclusions from these statistics on foreign bank participation.

No. 1, some time ago Tenneco outstripped the credit facilities available from U.S. banks. As the committee is aware, U.S. banks have legal lending limits and in addition have house limits which are generally more restrictive on borrowings to any one creditor. The foreign banks have effectively provided this shortfall.

First, they are very large. Now 7 of the 10 largest worldwide banking institutions and 15 of the top 20 are foreign. Second, they are extremely accessible. In Houston alone, we have offices of 37 foreign banks. They also provide large blocks of funds to creditworthy customers and last, they are exceedingly price competitive.

The second aspect of the internationalization of the capital markets from a corporate perspective is fixed-rate long-term borrowings from foreign capital markets. Tenneco began its program in 1968 with a $100 DM borrowing in the Euro-DM market. Today, we have borrowed the equivalent of over $1 billion, eight Eurodollar issues in the so-called Eurodollar market for a total of $750 million, 700 million deutschemarks, 75 million Swiss francs, 30 million pound sterling. Foreign currency borrowings are about the equivalent of $300 million in U.S. dollars.

FOREIGN BORROWING OF 20 PERCENT

In summary, about 20 percent of our long-term fixed rate borrowings have come from foreign capital markets.

Why has Tenneco turned to this foreign sourcing for its long-term capital? I could sum it up in one word—diversification. It's a different creditor source. It preserves our U.S. borrowing capacity. It also provides an offset to our asset exposure in foreign currencies.

In addition, there has been some savings in interest rate but, quite frankly, when I look at that advantage as contrasted with the other two, it is not as important.

The international capital market opportunities change continuously and one of my responsibilities as chief financial officer is to ensure that we are aware and take advantage of appropriate opportunities.

I'd like to briefly mention three opportunities that have occurred in the last 8 months, two of which relate to Japanese banking institutions.

The purchase of U.S. Treasury securities by the Japanese over the last year has been widely reported. In addition, at least six Japanese banks among the largest banking institutions in the world have also been actively soliciting borrowings with major corporate customers.

Late last summer Tenneco made a major pipeline acquisition for about $500 million and financed it on an interim basis with bank borrowings. It was an extremely complex financing because the credit for the financing was based on the projected future income and cash flow from the assets. There was no Tenneco guarantees involved. There was 6 weeks from the announcement of the offering until the closing. It was not an easy financing to understand. It required intimate knowledge of the pipeline industry and very complex credit judgments.

JAPANESE INVOLVEMENT

Being aware that the Japanese were enthusiastic lenders, we offered participation in this financing to four Japanese institutions. They all participated for a total of $135 million or a little over 25 percent of the total amount financed. They also were able to meet the schedule, recognizing of course that they were integrating the credit decisions with the judgments of management in Tokyo.

Parenthetically, the president of a major Japanese bank was in my office a few weeks ago in connection with the opening of an agency office in Houston and I asked this gentleman why at a time of the weak energy markets would they be making a major business initiative in a major energy market. His answer was:

> Mr. Blakely, the U.S. market is an extremely important one to us and we wish to do more here. The energy markets may be weak currently, but we are here for the long-term pull and we expect to stay a long time. Hence we proceed today.

My second example. Earlier this month we completed $50 million of subordinated borrowings for one of our finance companies on terms which were identical to a $62 million financing we completed in December 1985, with U.S. lending institutions. That particular financing was taken by two Japanese banks.

My last example: Next month Tenneco will become an issuer in the Euro commercial paper market. The U.S. commercial paper market has about $240 billion of outstandings of which Tenneco is $2.2 billion. The Euro commercial paper market is a fledgling market with about $10 billion outstanding. We believe, however, this market will grow very rapidly and as it provides Tenneco an alternate source of funds we wish to be an early participant.

Before closing, I would like to comment on one item mentioned in the letter to me from the committee. That has to do with foreign ownership and listing on foreign stock exchanges.

As the committee is aware, it is very hard to determine accurately the extent of foreign ownership. However, we estimate that about 6 percent or $300 million of market value in Tenneco common stock is held by foreigners. The majority of this ownership is with large foreign institutions. We have a very active investor relations program that is designed to maintain this foreign ownership base.

We also understand that the overwhelming majority of the trading by these foreign institutions occurs on the U.S. stock exchanges. Nonetheless, Tenneco is listed on eight foreign stock exchanges. To mention a number, Toronto, London, Paris, Zurich, Frankfurt. I believe it has some press relations value. I also believe it's an accommodation to small foreign shareholders. However, in our whole foreign ownership strategy, I must confess the foreign listings do not play a major part.

In conclusion, Tenneco is a large domestic company. It has, however, made heavy utilization of the international capital markets to finance U.S. operations. As the youngest among the Fortune top 20, an ambitious borrowing program has been integral to our growth strategy. The international capital markets are not only helpful; they are essential.

I hope my testimony has provided some perspective on the conclusion I offered in my introduction. The worldwide capital market is already with us. The future challenge will be maintaining or improving its efficiency.

Thank you.

[The complete prepared statement follows:]

The CHAIRMAN. Thank you, Mr. Blakely.

Mr. Lacy.

STATEMENT OF ALAN J. LACY, VICE PRESIDENT AND TREASURER, DART & KRAFT, INC.

Mr. LACY. Good morning. I'd like to thank you for this opportunity to share with you Dart & Kraft's experiences in international capital markets. I hope you will find my comments of help.

Dart & Kraft is a multinational, food, consumer, and commercial products company with sales totaling nearly $10 billion in 1985. The company was formed 5 years ago with the merger of Kraft and Dart Industries. Today, we rank among the top 35 industrial corporations in the United States and employ 72,000 people, approximately 45,000 of whom work in the United States. I should also mention that our direct selling business operates through an independent dealer force exceeding 90,000 people in the United States. We also have over 70,000 shareholders of record.

Our principal products are food and consumer related. Our quality food brands include Kraft, Parkay, Miracle Whip, Velveeta, Cracker Barrel, Breakstone, Breyers, and Sealtest. Our other consumer brands include Duracell batteries, West Bend cooking appliances, and Tupperware plastic food containers. In commercial products, we manufacture Hobart commercial food equipment and Wilsonart decorative laminates. Finally, we have a large automobile and equipment leasing operation.

EXTENSIVE INTERNATIONAL INTERESTS

Our international business interests are quite extensive. Approximately 30 percent of our sales and operating profit are generated outside the United States. We have over 100 subsidiaries in more than 30 countries. Many of these businesses have been in operation since the early 1900's. Kraft has major food operations in Canada, Australia, Germany, and Italy. Duracell is the largest battery company in Europe. Tupperware, working through an independent dealer force totaling over 200,000 people outside the United States generates over half its sales and profits abroad using the same party plan format as in the United States. Hobart has a significant international presence as well.

Dart & Kraft's involvement in credit and capital markets throughout the world has been both extensive and varied. Over the past 5 years, we have raised approximately $1.3 billion of new capital in the world's debt markets. These funds have been used for capital expenditures, acquisitions, hedging particular currency exposures and, occasionally, arbitrage investment in other financial assets.

In the U.S. markets, the types of debt financing we have undertaken include: commercial paper, continuously offered private placement medium-term notes, intermediate-term private placements, industrial revenue bonds, and borrowings from banks.

These types of borrowings account for approximately $900 million of the $1.3 billion I mentioned earlier.

Our financing activities outside the United States have included borrowings from local banks and commercial paper in Canada.

More important to this forum, we have raised approximately $250 million in five Eurobond market transactions involving three different currencies.

As you know, participation in international capital markets today involves more than debt offerings. Dart & Kraft has been actively using many of the newer asset and liability management tools. We have engaged in interest rate swaps both domestically and in conjunction with Eurobond offerings. We also have used foreign currency swaps, interest rate futures, and foreign currency options. In 1985, the underlying dollar volume of our use of these new techniques totaled approximately $500 million.

Of course, we continue to use the traditional foreign exchange forward contracts as well. In 1985, our contract volume was about $2 billion and involved approximately 40 currencies.

Before continuing with my remarks, I would like to outline Dart & Kraft's approach to financing its operations. Despite our rather decentralized approach of running our businesses around the world, we take a much more centralized view of how we finance our operations. We believe that centralizing this activity offers true economies of scale to a large, multinational company like Dart & Kraft. We try to operate as an internal bank for our businesses, seeking the lowest cost capital wherever we can find it. Therefore, although we raise capital outside the United States, it may be for use in the United States. Conversely, we may raise funds in the United States to finance non-U.S. operations. Occasionally, circumstances prevent us from acting in this manner. Typically, this results when capital controls in a country are restrictive or when we do not have adequate tools available to us to manage the currency risks involved. Examples here would include countries such as Greece and South Korea.

Generally speaking, we have found the U.S. commercial paper market to be the most attractive short-term market in the world and the Eurobond market the most attractive source of intermediate-term funds. The attractiveness to us of a source of funds is based on a combination of the quantity of the funds available, the cost of these funds, ease of access to the market, and flexibility in the terms and conditions of the documentation.

Our approach also includes taking a long-term view of our funding activity. Since we are in business for the long term, our financial strategies must mirror this time horizon. We are willing to take modest but carefully measured and considered risks, whether related to exchange rate movements, interest rate movements or country or counterparty credit risk. We will also pursue elaborate and complicated structures if the anticipated savings warrant it. Last, we try to deflate our worldwide and individual country balance sheets. Reallocating liquidity between our units that have excess cash and those that need it can produce significant savings.

In my written statement I tried to give you several examples of how we have used cross-market funding opportunities to our advantage.

SENATE BANKING COMMITTEE
TESTIMONY OF R. T. BLAKELY
FEBRUARY 27, 1986

I. Introduction

I am pleased to testify today about the internationalization of capital markets. As you know, Tenneco is an active and innovative user of both the U.S. and Euro-capital markets. Tenneco's growth has been spurred not only by internally generated funds, but also through acquisitions requiring considerable external financings.

I would like to begin by briefly describing Tenneco because our structure, and the fact that we have grown so quickly, both influence how we use the international capital markets. First, Tenneco is a large diversified energy company, and I believe we have been uniquely successful with our diversification program. We were founded as a natural gas transmission company in 1943, and in the years since we have expanded into ten major businesses largely through acquisitions.

Using cash flow from pipeline operations and external borrowings, Tenneco expanded into oil and gas exploration in the 1950's to ensure a secure supply of natural gas for our pipeline system. The Company then diversified further in the 1960's into refining and marketing of oil products, as well as manufacturing, chemicals and life insurance. There were two key acquisitions in the 1960's. One was the Kern County Land Company, a company with major oil reserves in California, which also owned an automotive parts company called Walker, and a farm and construction equipment manufacturer called J I Case Co. The other company, bought in 1968, was Newport News Shipbuilding, which was in a heavy loss position at the time of the acquisition. Today it is a well-managed defense contractor known to all of you.

At year-end 1984, Tenneco was the youngest company among the top twenty on the Fortune 500. Tenneco was ranked 19th in sales, 15th in assets, and 19th in net income. It is our estimate that Tenneco's consolidated debt level would place it among the top 10 of the Fortune 500 industrials.

Because Tenneco has grown primarily through acquisitions, we have had to raise a substantial amount of capital to finance them. Having access to and continuous use of the capital markets has been essential to our development and evolution.

Our first international financing occurred in 1968 when the company borrowed 100 million deutsche marks, because of interest rate savings. I must say, in retrospect, that this decision was badly timed in view of the deutsche mark exchange rate appreciation that took place in the 1970's and early 1980's. Although this offering was modest and ill-timed, it was the beginning of a long list of borrowings, which helped Tenneco's expansion in the later decades. Very importantly, in my opinion, Tenneco's expansion could not have been accomplished without free access to the international capital markets.

II. Total Corporate Borrowings

To give you some indication of the use and dependency that our company has on borrowings, I will give you a comparison between 1975 and 1985.

- Consolidated total borrowings in 1975 were $2.8 billion; in 1985 they were $7 billion, an increase of 250%.
- Corporate bank lines were $620 million in 1975 vs. $3.2 billion in 1985.
- Interest expense went from $220 million in 1975 to $815 million in 1985, a 370% increase.

III. Reasons for Increased Borrowings

Obviously, there are major reasons for such significant increases in Tenneco's borrowings between 1975 and 1985. The most important opportunities were in our oil and gas business. Oil prices increased from $7.79 in 1975 to $22.36 in 1985, with a peak slightly over $30.00 in 1981. Likewise, natural gas prices increased from 35¢ per MCF to $2.50 per MCF.

Tenneco's capital expenditures in the Exploration and Production portion of our Oil Company, alone, increased from $200 million in 1975 to $850 million in 1985. Not only were there significant profit opportunities during this period in oil but, of paramount importance, was the need to secure sufficient natural gas supplies for the Company's pipelines.

Tenneco's increased borrowing requirements were also a result of our corporate strategy to build and round out existing operations. Although the outside world's perception of Tenneco may be different, we actually have not entered any new businesses since 1968. We have, though, spent heavily for acquisitions to round out existing lines. Such acquisitions include Monroe Auto Equipment, Goodyear's Natural Gas Pipelines in Louisiana, Southwestern Life Insurance Company, Houston Oil & Minerals, etc.

We have also spent very large amounts of money on projects such as the North Yard at Newport News, where nuclear aircraft carriers and submarines are currently being built. Also, Tenneco upgraded its refinery, at a cost of $600 million, enabling our refining and marketing company to refine lower grades of crude oil, as well as to take advantage of price changes in crude oil used by the refinery.

Interestingly, although debt greatly increased during the 1975 to 1985 period, equity was also used very liberally in our acquisitions. Almost one third of Tenneco's common shares currently outstanding were used for acquisitions. In addition, during that period, various forms of preferred stock, totalling $675 million, were also issued.

It is clear that Tenneco could not have grown as successfully to the size it is today if it had depended solely on internally generated funds. From a level of $2.5 billion at year end 1975, the company's long term debt is today $6.4 billion dollars. Accomplishing this $4 billion increase in long-term debt at a reasonable interest rate required utilization of both the domestic and foreign capital markets.

IV. Transition -- How Tenneco Has Financed

Getting back to Tenneco's finances, Tenneco's corporate borrowings are comprised of short-term floating rate borrowings such as commercial paper and master notes. Commercial paper totals $900 million and carries an average maturity of forty-five days. Both commercial paper and master notes, which are funds provided by bank trust departments, are fully backed by bank credit lines. In addition to these borrowings, we also use direct bank borrowings of $1 billion, which are split evenly between domestic and foreign creditors. Finally, Tenneco has long-term fixed rate debt totalling $4.7 billion.

V. Bank Credit Facilities

Regarding bank credit facilities, the company currently has $3.2 billion, of which almost one-third is provided by non-U.S. banks. In 1975, the domestic bank facilities totalled only $620 million, with foreign facilities being $75 million, representing 12% of the total. The dramatic change in ten years is indicative of the increased importance of the Euro-dollar market, as well as Tenneco's greater dependency on the major European, Canadian and Japanese banks.

Parenthetically, I must add that the absence of U.S. exchange controls and liberalized exchange controls in both the European countries and Japan enabled the major foreign banks to lend to large U.S. customers like Tenneco. Further, the availability of such cash is probably a result of the recycling of the U.S. trade deficit and, most particularly, funds relating to U.S. corporations' purchase of crude oil from foreign sources.

The purpose of such bank facilities is to support Tenneco's commercial paper and master notes since it is the Company's policy to provide a 100% liquidity back-up for these money market borrowings. In addition to the parent's borrowings, we have $2.3 billion of credit lines in four captive credit companies -- two in the U.S., one in Canada and one in the U.K. These credit facilities in the finance companies are supplied by both foreign and domestic banks. It is interesting to note, however, that foreign banks supply a higher percent -- 54% -- of these finance company credits.

The purpose of the bank facilities, in addition to the type of liquidity back up I just referred to, are for on-going working capital requirements, as well as interim finance until short-term debt is funded out in the long-term markets. The bank credits also provide an availability, which can be used on a temporary basis, for acquisitions.

If we take the parent bank facilities as well as those of our finance companies, which total $5.5 billion, the U.S. banks provide 60% of the total; Canadian banks provide 14%, U.K. banks 6%, French banks 6%, German banks 5%, Swiss banks 2%, Japanese banks 2%, and other foreign banks 5%.

Clearly, Tenneco's capacity long ago outstripped availability provided by the U.S. banks. This is attributable to legal lending limits of the U.S. banks, and in many cases what is called a "house limit", which is lower than a bank's legal limit. Further, there is always the credit judgment of each separate bank. As would be expected, not all the credit provided by the large U.S. banks is available to a company, even to a name like Tenneco.

The other restriction, which we have experienced in the U.S. market, is that it is too time consuming and just not cost effective to tap the credit availability of the smaller U.S. banks. Generally, with respect to credit, we do not tap U.S. banks having an asset value lower than $3 billion.

As previously mentioned, of the total bank credit provided to Tenneco and its finance companies (and I am excluding funds granted to our foreign operating subsidiaries), 40% is provided by foreign banks. We once had an arbitrary rule that no more than 30% of total lines would come from foreign banks; as our needs increased, this ratio no longer could be heeded.

The reasons for tapping the foreign bank credits are many. In addition to the shortfall in U.S. bank availability, the foreign banks are very large, they are accessible, and they have large amounts of funds available to credit worthy customers generally without the restriction of severe "house" or legal lending limits. In addition, the foreign banks are exceedingly price competitive relative to their U.S. competitors.

VI. Long-Term Debt Markets

As I stated earlier, Tenneco began borrowing in the Euro markets in 1968. Between 1968 and 1971 we borrowed the equivalent of $120 million in deutsche marks and Swiss francs. Our first Euro dollar offering was in 1972 with an issue of $50 million. From 1972 through 1985, we borrowed $750 million in eight Euro dollar issues. In the Euro currency markets over the years, Tenneco has borrowed 700 million deutsche marks, 75 million Swiss francs and 30 million pounds sterling -- the equivalent of over $300 million. The large deutsche mark and sterling issues from 1982 onward were done to reduce the fluctuation in the value of our assets denominated in non-dollar currencies.

Further, there were very significant interest rate savings in our recent deutsche mark issues compared to an equivalent borrowing in U.S. dollars. In addition to exposure offset and interest rate savings, the foreign currency bonds provide a different creditor source from those who buy Euro dollar bonds. If we take the 1968 to 1985 time period, Tenneco accessed the U.S. market for a total of $4.8 billion, compared with a total of $1.1 billion from the Euro markets. This works out to 19% coming from the Euro markets. The Euro market did not supply as high a percentage of the total as the bank facilities, but we utilized this market to attract different creditors, and most importantly, to preserve our borrowing capacity with financial institutions in the U.S. The interest rates of the issues are of limited importance since there are not significant differences, other than timing, between the U.S. and Euro markets.

VII. Examples of Recent International Market Opportunities -- 1985

Obviously, the international markets are changing quite dramatically. I will mention three new areas in which we are currently involved. The first is the very noticeable increase in availability of dollars from Japanese sources. As I have stated, our traditional foreign source for dollars and foreign currencies has been Europe. With the U.S.'s trade deficit with Japan, not only are the Japanese purchasing U.S. Treasury securities, but we are also seeing a greater availability of dollars provided by their banks. This availability is principally provided by about six banks, in very large amounts. The Japanese banks actively solicit business and their pricing is competitive.

It is interesting to note that the Japanese banks established their "beach head" with Tenneco by providing funds in the overnight markets at a rate cheaper than any of their U.S. competitors. I consider overnight money as funds provided for a period from one day to one week -- in other words, exceedingly short maturities. With very high fluctuations in Tenneco's daily consolidated cash flow, this overnight money becomes a balance wheel in settling our daily cash position. Parenthetically, I might add, the major European banks are also providers of this money in sizeable amounts. The price competitiveness of the Japanese banks has not slackened even though they now provide other facilities. For instance, in 1985, four Japanese banks provided term credit for a pipeline acquisition that Tenneco financed. Recently, two Japanese banks loaned long-term subordinated debt to one of our finance companies. Clearly, money from Japanese banks is a new source of funds that is opening up to the American corporation.

Although the U.S. commercial paper market now totals $240 billion, a close replica of this market is in its infancy in London. The future size of the market is unknown, but Tenneco believes that it could evolve into a very large market. This market is now only $10 billion in size. It is just beginning, but we feel it is a trend that bears close watching. It is believed, incidentally, that as the Euro commercial paper market develops, that holders of excess dollars will buy the Euro commercial paper of U.S. and European companies, thus reducing their purchases of U.S. bank Euro certificates of deposit.

Tenneco has $2.2 billion of commercial paper outstanding in the U.S. It is the intention of our company to issue in the Euro commercial paper market in order to understand more fully how it operates, and then to tap it as an alternate source of funding to the U.S. market. From what we can determine, the same U.S. investment banking dealers, who have been so successful in the U.S., will also operate in London.

An additional international finance project has been Tenneco's recent start-up of a Canadian finance company. This company was begun in order to finance Canadian receivables with Canadian dollars, thereby reducing currency exposure. Again, as is the case in other areas of the world, this financing taps a new market. The funds were provided through a medium comparable to U.S. commercial paper, but with the insertion of a bank guarantee. All the large Canadian banks, as well as the major American banks operating in Canada, provide this financial service.

VIII. Organization

Tenneco has positioned itself to take advantage of the international money markets. We started a London finance office in 1974. Its purpose was to be close to our operating companies, the bank credit markets, and by being in London, to understand more fully the foreign exchange markets. We have established a large finance company, which purchases trade receivables of our foreign subsidiary companies.

By operating out of London, we have very successfully tapped the local currency markets of the countries where our subsidiaries are established. These amounts borrowed total the dollar equivalent of $720 million.

Interestingly, I might add, there are virtually no American banks providing local currency to our foreign operating subsidiaries. Practically all funds come from the sovereign European banks.

The London office is an adjunct of our Houston office. The main office is responsible for overall financing strategy. This includes all long-term financing and swaps in all markets, all short-term financing from banks creditors, and management of foreign balance sheet currency exposure.

IX. Conclusions

In conclusion, U.S. trade deficits have created large pools of U.S. dollars outside the control of the United States. For companies such as Tenneco that are large users of capital, it is important to tap this market. The pricing of Euro dollars and Euro currencies is very competitive, and at times, is even more attractive than what is available in the U.S. capital markets.

As far as Tenneco is concerned, we would not have been able to grow as a company and obtain the necessary capital in the United States, not only because of market capacity, but also because of legal and house limits of the banks. We look favorably on these international markets to meet our growth objectives, and we certainly hope these will continue without significant interruptions.

INTERNATIONAL INVESTMENTS

I would also like to describe how we invest funds internationally. Dart & Kraft has monetary assets worldwide of over $2.5 billion. These funds include excess operating cash and pension and trust fund assets in several countries in which we operate. Our excess operating cash is typically invested in money market instruments. Today, approximately $350 million of our U.S. and European cash is invested in Euro deposits. This is because the improved rate of return more than offsets the reduced liquidity we accept on these investments.

We have approximately $100 million, or 9 percent, of our U.S. pension plan assets invested in international equities. We believe that non-U.S. equity markets are attractive and that international diversification can lower overall portfolio risk and improve returns. These benefits of international investment outweigh the added currency risk. Certain markets, particularly in Asia, offer greater earnings growth prospects than in the United States. In addition, some markets are not as efficient in valuing securities; therefore, they offer even greater potential for return improvements. Although the U.S. equity market was up over 30 percent in 1985, our foreign stock portfolios increased roughly 50 percent in dollars during that year. Further internationalization of equity investing is taking place as American depository receipts of foreign equities now appear with regularity in the portfolios of our U.S.-based investment managers. We believe the internationalization of U.S. pension assets will continue.

Separately, the pension assets of our operations in Australia, Canada, and the United Kingdom have historically contained investments outside of their domestic capital markets.

The share ownership of Dart & Kraft reflects the internationalization of equity markets. Although precise numbers are hard to determine, we estimate that 12 percent of our shares are held by non-U.S. investors. This represents an investment of over $750 million, double what we estimated foreign ownership to have been 5 years ago. We have actively tried to encourage increased foreign ownership of our shares. We are listed on stock exchanges in seven countries outside the United States and conduct annual investor relations meetings in the major markets. We believe foreign investors are attractive owners of our company because they tend to be longer term holders than most U.S. institutional investors. We are beginning an active investor relations program to encourage more ownership by Japanese investors and this may lead to a listing there.

As I hope you have gathered from Dart & Kraft's experiences, we view the internationalization of capital markets very favorably. For companies such as ours, the ability to raise capital in many different markets and in such custom-made fashion offers tremendous benefits.

I believe the evolution of the Eurobond market and the swap market has been an important development. The Eurobond market has developed long-term sources of funds at low cost for many currencies such as lira, New Zealand dollars and Australian dollars that simply didn't exist before. It has enabled U.S. companies to raise dollar funding at lower rates than they could obtain in the United States. Furthermore, the large amount of debt issued by U.S. companies in the Eurobond market has obviously aided the U.S. economy by not competing with the issuance of the large level of Government debt required to finance our Federal deficit.

The swap market has provided significant benefits as well. Swaps allow parties to use their own relative advantage in one market to aid them in another. If I have the greatest advantage in the U.S. short-term market, I can pass this benefit to another party in exchange for, perhaps, their more efficient access to longer term markets.

Overall, I do not see any major risk in internationali- zation. I believe the more intertwined our financial interests, the more likely it is we will coordinate our economic policies, which helps reduce some of the risk of international business. Along these same lines, I would like to say that international capital flows thus far have had a major impact on the value of the dollar and in satisfying this country's need for capital. I believe it is of the utmost importance that our domestic economic policies take into account the interests of these investors. If we mismanage our economy to the point that investors lose confidence in the attractiveness of U.S. investments, we run a great risk of paralleling the experience of many Latin American countries and potentially losing access to valuable worldwide sources of capital.

Thank you.

[The complete prepared statement follows:]

Statement of

Alan J. Lacy
Vice President and Treasurer
Dart & Kraft, Inc.

on

Internationalization of Capital Markets

Before the
United State Senate Committee
on Banking, Housing and Urban Affairs

February 27, 1986

My name is Alan Lacy. I am Vice President and Treasurer of Dart & Kraft. I would like to begin by thanking you for this opportunity to share with you Dart & Kraft's experiences in international capital markets. I hope you will find my comments on this complex topic helpful.

Dart & Kraft is a multinational, food, consumer and commercial products company with sales totalling nearly $10 billion in 1985. The company was formed five years ago with the merger of Kraft and Dart Industries. Today, we rank among the top 35 industrial corporations in the United States and employ 72,000 people, approximately 45,000 of whom work in the United States. I should also mention that our direct selling business operates through an independent dealer force exceeding 90,000 people in the U.S. We also have over 70,000 shareholders of record.

Our principal products are food and consumer related. Our quality food brands include Kraft, Parkay, Miracle Whip, Velveeta, Cracker Barrel, Breakstone, Breyers and Sealtest. Our other consumer brands include Duracell, West Bend and Tupperware. In commercial products, we manufacture Hobart commercial food equipment and Wilsonart decorative laminates. Finally, we have a large automobile and equipment leasing operation.

Our international business interests are quite extensive. Approximately 30 percent of our sales and operating profit are generated outside the United States. We have over 100 subsidiaries in more than 30 countries. Many of these businesses have been in operation since the early 1900's. Kraft has major food operations in Canada, Australia, Germany and Italy. Duracell is the largest battery company in Europe. Tupperware, working through an independent dealer force totalling over 200,000 outside the U.S., generates over half its sales and profits abroad using the same party plan format as in the United States.

Dart & Kraft's involvement in credit and capital markets throughout the world has been both extensive and varied. Over the past five years, we have raised approximately $1.3 billion of new capital in the world's debt markets. These funds have been used for capital

expenditures, acquisitions, hedging particular currency exposures and, occasionally, arbitrage investment in other financial assets.

In the U.S. markets, the types of debt financing we have undertaken include:

- Commercial Paper
- Continuously offered privately placed medium-term notes which are similar to commercial paper but have a longer maturity.
- Intermediate-term private placements
- Industrial revenue bonds
- Borrowings from banks

With the exception of bank borrowings, each of these activities typically has involved investment bankers. Investors in these securities have included money market funds, banks, trust departments, investment advisors, insurance companies and individuals. These types of borrowings account for approximately $900 million of the $1.3 billion I mentioned earlier.

Our financing activities outside the U.S. have included borrowings from local banks and commercial paper in Canada. More important to this forum, we have raised approximately $250 million in five Eurobond market transactions involving three different currencies. As in the U.S., most of these transactions have involved an investment banker.

As you know, participation in international capital markets today involves more than debt offerings. Dart & Kraft has been actively using many of the newer asset and liability management tools. We have engaged in interest rate swaps both domestically and in conjunction with Eurobond offerings. We also have used foreign currency swaps, interest rate futures and foreign currency options. In 1985, the underlying dollar volume of our use of these new techniques totalled $500 million.

Of course, we continue to use the traditional foreign exchange forward contracts as well. In 1985, our contract volume was about $2 billion and involved approximately 40 currencies.

Before continuing with my remarks, I would like to outline Dart & Kraft's approach to financing its

operations. Despite our rather decentralized approach of running our businesses around the world, we take a much more centralized view of how we finance our operations. We believe that centralizing this activity offers true economies of scale to a large, multinational company like Dart & Kraft. We try to operate as an internal bank for our businesses, seeking the lowest cost capital where ever we can find it. Therefore, although we raise capital outside the U.S., it may be for use in the U.S. Conversely, we may raise funds in the U.S. to finance non-U.S. operations. Occasionally, circumstances prevent us from acting in this manner. Typically, this results when capital controls in a country are restrictive or when we do not have adequate tools available to us to manage the currency risks involved.

Generally speaking, we have found the U.S. commercial paper market to be the most attractive short-term market in the world and the Eurobond market the most attractive source of intermediate-term funds. The attractiveness to us of a source of funds is based on a combination of the quantity of the funds available, the cost of these funds, ease of access to the market, and flexibility in the terms and conditions of the documentation.

Our approach also includes taking a long-term view of our funding activity. Since we are in business for the long term, our financial strategies must mirror this time horizon. We are willing to take modest but carefully measured and considered risks, whether related to exchange rate movements, interest rate movements or country or counter-party credit risk. We will also pursue elaborate and complicated structures if the anticipated savings warrant it. Lastly, we try to deflate our worldwide and individual country balance sheets. Reallocating liquidity between our units that have excess cash and those that need it can produce significant savings.

I would like to give you a few examples of transactions we have completed which may help you better understand what I mean. To begin with, Dart & Kraft's access to the U.S. commercial paper market presents excellent opportunities for us in providing low-cost funds to many of our non-U.S. operations. Since we can access this market at a cost below the funding costs of

commercial banks, using commercial-paper-sourced funding to construct loans to our foreign subsidiaries offers meaningful savings. Currently, we provide nearly $450 million of funding directly from the U.S. to several of our foreign operations. These loans are usually denominated in the currency of the borrowing unit. We then manage the foreign exchange exposure on our books. The net effect of this approach is that our foreign operations have attractively priced local currency funding and we have sourced these funds less expensively than banks could have sourced them and saved the banks' profit margin as well. We estimate that this method of financing saves us over $5.5 million annually.

In addition, intercompany lending can provide funds for a maturity that may not be available in the local market on a fixed-rate basis. As excess cash in one region is reallocated to one needing funds, this activity also deflates our worldwide balance sheet.

Another example of the U.S. assisting our foreign operations is the way we financed some recent acquisitions in Italy. Long-term fixed-rate funds are difficult to obtain in Italy. In addition, local market interest rates are very high. We also are concerned that the lira may not maintain its value against the dollar, thus reducing the dollar value of our investment. Our solution was to use excess cash in the United States to the benefit of our Italian operations. By providing dollar deposits to an Italian institution on favorable terms, the Italian institution in turn provided our operations with attractively priced, long-term lira. In addition, raising lira in this fashion acted as a hedge against the devaluation of that portion of our investment, saved us approximately $1.2 million annually in interest cost, and has protected us from over $11 million of currency devaluation.

I have two examples of international capital markets helping to satisfy our financing requirements in the U.S. First, as you will recall, in early 1982 interest rates in the United States were very high. Rather than borrowing in the U.S. market, we took the opportunity to finance in the Eurobond market in Kuwaiti dinars at rates three and four percent below what was available in dollars. Obviously, we took some currency risk, but our analysis showed that the dinar was

primarily dollar linked, since that country's principal asset is dollar-based oil revenues. Additionally, we generate significant dinar cash flow through exports of our food products from our Australian operation. The result has been an attractively priced financing at savings of $750,000 per annum versus a comparable financing in dollars.

Also in 1982, we chose to fund our normal seasonal working capital requirement through bank borrowings denominated in Deutsche Marks, Japanese Yen and Dutch Guilders. For this short period, we felt that interest-rate savings of over four percent versus commercial paper more than offset the potential foreign exchange risk. This saved us over $5 million of interest costs.

Perhaps our most unusual transaction in the Euromarket was an $85 million debt financing with equity warrants issued in 1984. The equity warrants were not rights to purchase Dart & Kraft stock, but rather to purchase the stock of the 3M Company. Dart & Kraft held a large number of shares of 3M following the sale of a business to 3M. At that time, Eurobond market investors had not had the ability to buy many equity-related securities of U.S. companies. Previous opportunities typically involved smaller companies that lacked a solid credit standing. By offering Eurobond investors a security containing both Dart & Kraft's high credit quality and an equity play on a blue chip company such as 3M, we were able to set pricing terms significantly better than could have been achieved in the U.S. market. We have estimate that going to the Euro market on this issue saved us $5 million.

My last example relates to a transaction that didn't involve the U.S. capital market at all. Dart & Kraft has two small operations in New Zealand. In 1983, one of these operations was in need of funds. However, interest rates in New Zealand were quite high and long-term availability of funds was uncertain. Structuring a U.S. dollar loan was unattractive because our operation could not afford to take what we believed was a significant amount of exchange risk and a long term forward market or swaps to help manage this risk did not exist. As a solution, we issued bonds denominated in New Zealand dollars to European investors at rates below existing short-term rates in New Zealand, saving us

$120,000 per year. This transaction also neutralized the foreign exchange risk to our New Zealand operation and protected us from what would have been $1.6 million in subsequent devaluation losses.

Thus far, I've discussed only our approach to raising funds. Before concluding, I would like to describe how we invest funds internationally. Dart & Kraft has monetary asset worldwide of over $2.5 billion. These funds include excess operating cash and pension and other trust fund assets in several countries in which we operate. Our excess operating cash is typically invested in money market instruments. Today, approximately $350 million of our U.S. and European cash is invested in Euro deposits. This is because the improved rate of return more than offsets the reduced liquidity we accept on these investments.

We have approximately $100 million, or 9 percent, of our U.S. pension plan assets invested in international equities. We believe that non-U.S. equity markets are attractive and that international diversification can lower overall portfolio risk and improve returns. These benefits of international investment

The **Chairman**. Thank you, Mr. Lacy.

Mr. Blakely, you talked a good deal about the reasons for your going overseas—in-house limits, legal limits, interest rates. Yesterday we had testimony from domestic bankers as well as people from our own stock exchanges, and then we had their counterparts from Great Britain primarily.

The testimony was interesting. In listening to our own people discuss the situation you would think that the major problems were nothing but regulation, Glass-Steagall, delays due to issuing restrictions and the like, and that there were no similar restrictions standards in overseas markets. This of course compelled the British to say at the outset, "I want you to know, Senator, we do have standards, we do have regulations. We're not totally out there operating out of our back pocket."

What is your impression of the difference in regulation, not in-house limits, restrictions, and interest rates, but regulation? What has been your experience? Do differences in regulation put our banks, our financial institutions, at a severe competitive disadvantage?

Mr. **Blakely**. Mr. Chairman, as you would appreciate, my perspective would obviously be a different one.

I think probably one issue which is of concern to us, of course, is the question of disclosure in the various offering documents that we use throughout the world in our financing. From our perspective, we take exactly the same standard regardless of the market that we're in. Quite frankly, our view is that the standards in the United States as provided by the Securities Act of 1933 are as demanding as any.

From the point of view of restrictions or mechanical difficulties associated with issuing in any foreign capital markets, quite frankly, day in and day out they are not a major issue and, quite frankly, day in and day out I'm just not aware of them. When we decide to take a decision, for example, to go into the Eurobond market, the question of mechanical difficulties of entering that market versus the United States just does not come up as an issue.

The **Chairman**. Mr. Lacy, what's your experience? We wanted the testimony today to provide a different perspective. You are the users of the capital, not its dispensers.

ADVANTAGES OF FOREIGN BANKS

Mr. **Lacy**. I think to your point as to whether or not we see that the U.S. banks are more or less competitive because of regulations, we think that the foreign banks seem to have an advantage based on the fact that the U.S. banks are more tightly regulated in terms of capital requirements and therefore must charge a higher rate of return.

The **Chairman**. Beyond the issue of regulation, what about the issue of time? Both of you have spoken about foreign banks being able to respond more quickly. Is that internal to their operation compared to large U.S. banks?

Mr. **Blakely**. I think, Mr. Chairman, I would say the point I was trying to emphasize was that despite the fact that they may be headquartered in a different time zone and many thousands of miles, I find on average they can respond just as rapidly as the U.S. banks. So as to the time differences I feel that the foreign banks have no disadvantage or advantage and I think that was the only point I was trying to make.

Mr. **Lacy**. I guess our experience would be that it depends on the institution. Some of the U.S. banks and some of the foreign banks are very much on top of things. Others just lag behind.

The **Chairman**. Mr. Blakely, you gave examples of some of the Japanese banks, current lending to the energy industry right now because of the recession in that area and their wanting to be participants for the long term. Are they simply buying the business at this point, a typical Japanese tactic in manufacturing projects—that is, to do whatever is necessary to get the business; or are they being unfairly competitive by trying to buy your business at this point for the time when the energy business comes back and you would say, "Gee, they were nice to us when no one else would be."

Mr. **Blakely**. I think it's fair, Mr. Chairman, to say they have met the competition head-on. They have been prepared to respond as rapidly as the U.S. banks. They have certainly been at the cutting edge on pricing of the loans that we've been involved in.

Whether they are attempting to buy business per se, I don't believe that's the case, as I best know it from the examples that we've worked on specifically. But I would emphasize they have certainly been prepared to meet the pricing terms that have been offered by the banking institutions from any place else in the world.

[Additional information was subsequently received for the record follows:]

Tenneco Inc

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TENNECO

Robert T. Blakely
Senior Vice President
and Chief Financial Officer

March 11, 1986

Senator Jake Garn
Chairman
United States Senate
Committee on Banking, Housing,
and Urban Affairs
Room SD-534
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Garn:

You may remember during my testimony on Internationalization of the Capital Markets on February 27, 1986, you asked me whether the Japanese were in effect "simply buying the business" in banking as they had done in manufacturing. Upon reflection I had one additional thought which I felt appropriate to share with you.

Tenneco's experience has been, as I indicated, that the Japanese are aggressive lenders. Their method of operation suggests participation or leadership by a major U.S. financial institution is an important consideration for Japanese participation. I believe participation with a major U.S. institution provides a degree of comfort and confidence for the Japanese as their credit sophistication develops in the U.S. market.

The Japanese are generally prepared to then participate with identical pricing terms to that of the U.S. financial institutions. Our observation tends to suggest they are unlikely to further improve the pricing terms through the levels proposed by U.S. financial institutions to in effect obtain a larger share.

Again thank you very much for the privilege and opportunity to testify before the Senate Banking Committee, and I hope this letter clarifies one issue raised during questioning.

Warmest regards,

Bob Blakely

RTB/ccs

The CHAIRMAN. Are you aware of any Japanese Government involvement to aid them like we've seen in so many other cases involving foreign companies? For example, are your aware of any practice like the predatory financing with French companies where they simply undercut the market without any competitive justification for going that low and the French Government has simply as a matter of national policy that they are going to get that business?

Mr. BLAKELY. Mr. Chairman, I am not aware of it; but on the other hand, there's a chance—I might not be aware of it even if it were to occur anyway, quite frankly. It's just not something I have spent much time investigating.

The CHAIRMAN. Mr. Lacy, which exchanges is your company listed on?

Mr. LACY. Exchanges in Germany, Switzerland, United Kingdom, France, the Netherlands, Belgium, and Australia.

The CHAIRMAN. How did you determine where you would list?

PUBLIC RELATIONS PART IN LISTING

Mr. LACY. I guess the rationale was one of public relations for the most part. With the exception of the French listing, none of the listings that we have engaged in really offer a whole lot we feel as a depth of market or liquidity mechanism. It's really been as a support to our employees in those countries, many of whom have shares in Dart & Kraft as part of their employee benefit plans. We've really done it more from the public relations standpoint.

The CHAIRMAN. In listing on different exchanges around the world, does this give you a problem as far as having to comply with different regulatory requirements?

Mr. LACY. Not a burdensome one. It's simply a matter of translation of documents into the local language.

The CHAIRMAN. Yesterday, as I mentioned, the representatives from England commented that high but efficient regulatory standards are becoming increasingly important in their view, but that instilling investor confidence can be achieved without going overboard. In other words, what they are trying to say, nicely again, is, "We have regulation, we're just more efficient in the way we do it; we don't provide over-burdensome regulations; we can move faster."

What changes, if any, would either of you make in U.S. standards? Because I get the feeling, no matter what any of them say, that there are some very distinct advantages that the overseas banking institutions and stock markets have as a result of not having the strict regulations. Don't misunderstand me. As Senator Dodd was saying yesterday, we don't want to suddenly throw the baby out with the bath water and throw the SEC out and dramatically change the regulations. That's not what I'm talking about.

But I'm wondering if you have any recommendations as a result of your working with both markets of how we might ease up on that competitive advantage that I do believe exists for the overseas institutions.

Mr. BLAKELY. I don't have a comment, Mr. Chairman. I think from my perspective of raising capital in the various capital markets that the difference in regulation, quite frankly, day in and day out is not a major issue. And I could see from the point of view of the financial institutions they might raise it, but from the users' perspective it is not an issue.

The CHAIRMAN. Well, they definitely think it is. They think they're losing business as a result of that.

Mr. BLAKELY. I guess I would argue, Mr. Chairman, that the issue is probably more one of price competitiveness than it is one of regulation, at least as we see it, as the central issue in the relative change in our own bank facilities and borrowing facilities as they've moved more toward foreign sourcing.

The CHAIRMAN. Mr. Lacy, do you have any comment?

Mr. LACY. I'm not sure that I've got a particularly good one myself, but I guess I would suggest that as an investor of funds we obviously take a fairly strong look as to the credit quality of the financial institutions and on the whole we must admit that we find the extra reporting requirements and capital requirements of U.S. banks comforting from that perspective, particularly in light of some of the LDC problems and oil problems and that type of thing.

The non-U.S. banks obviously lack some of those regulations, but I guess in that instance we look and see probably a little bit more direct support of their local central bank in terms of the credit quality of those institutions. So although we like the disclosure aspects and the concepts of some of the improved capital requirements for U.S. banks from a credit perspective, if the U.S. Government would take perhaps a more active supporting role of those institutions as it appears that other governments and their central banks have done this level of regulation in the United States may not be required to provide investors with comfort as to the credit quality of U.S. banks.

UNIFORM REPORTING SYSTEM

The CHAIRMAN. You mentioned reporting regarding your overseas investment opportunities. Would you favor a uniform reporting system?

Mr. LACY. I think that would make everybody's life easier, yes.

Mr. BLAKELY. I would think, Mr. Chairman, the practical realities of that would be very, very difficult to achieve. We live obviously, as Mr. Lacy does, day in and day out with converting all our foreign companies' accounts to U.S. accounting standards and just having an appreciation of what's involved in that I would think as a practical matter, while it would certainly facilitate reporting from our perspective, the practical realities would make it a very challenging task to take that on.

The CHAIRMAN. Mr. Lacy, do you regard it more risky to invest the assets of your pension fund in international markets rather than the United States?

Mr. LACY. Yes; to some extent, because you do have an extra currency risk that you wouldn't otherwise have, but as I stated in my remarks, we think there are other benefits that outweigh that additional risk from a return standpoint and that would be that that's a higher growth profile in many of those markets and to some extent less efficient capital markets provide more opportunities to pick good investments.

The CHAIRMAN. Mr. Blakely, in general, do you feel that it's more risky to raise money in currencies other than the dollar?

Mr. BLAKELY. Mr. Chairman, I think unless the corporation has the underlying asset base in the currency in which it's raising the funds or does currency swaps or other mechanisms to in effect hedge that exposure, it absolutely is more risky. In fact, I mentioned in my written comments and also my comments this morning that we did an issue in 1968 in the deutsche mark market. We didn't have assets in Germany at that time and the financing was done to take advantage of an unusually low-interest rate. Over time that proved to be a poor judgment because the strengthening of the deutschemark took away the advantage of that lower interest rate.

So I think it has to be based on sound financial fundamentals as I said, either hedged or with the assets in place. Otherwise, it's an extremely risky proposition in my judgment.

The CHAIRMAN. Gentlemen, I appreciate your willingness to testify very much. Your testimony is very helpful to give us a specific picture of what's going on. The international capital markets have been exploding so rapidly and we've received a lot of general information, it's helpful from operating companies to know exactly what your perspective is. At this point I will insert the statement of Mr. Peter Houchin. Thank you very much.

[The statement of Mr. Peter Houchin follows:]

outweigh the added currency risk. Certain markets, particularly in Asia, offer greater earnings growth prospects than in the United States. In addition, some markets are not as efficient in valuing securities; therefore, they offer even greater potential for return improvements. Although the U.S. equity market was up over 30 percent in 1985, our foreign stock portfolios increased roughly 50 percent in dollars during that year. Further internationalization of equity investing is taking place as American Depositary Receipts of foreign equities now appear with regularity in the portfolios of our U.S.-based investment managers. We believe the internationalization of U.S. pension assets will continue.

While internationalization of U.S. pension plans is a relatively recent trend, the pension assets of our operations in Australia, Canada and the United Kingdom have historically contained investments outside of their domestic capital markets. Canada, however, limits the amount of external investment of pension assets to 10 percent. The United Kingdom has dropped its restrictions and about 16 percent of the pension assets of our operations there are now invested outside of the U.K. domestic market. Our Australian pension assets have a similar level of non-domestic investments.

The share ownership of Dart & Kraft reflects the internationalization of equity markets. Although precise numbers are hard to determine, we estimate that 12 percent of our shares are held by non-U.S. investors. This represents an investment of over $750 million, double what we estimated foreign ownership to be five years ago. We have actively tried to encourage increased foreign ownership. We are listed on stock exchanges in seven countries outside the United States and conduct annual investor relations meetings in the major markets. We believe foreign investors are attractive owners of our company because, they tend to be longer-term holders than most U.S. institutional investors. We are now beginning an active investor relations program to encourage more ownership by Japanese investors. This may lead to a listing there.

As I hope you have gathered from Dart & Kraft's experiences, we view the internationalization of capital markets very favorably. For companies such as ours, the ability to raise capital in many different markets and in such custom-made fashion offers tremendous benefits.

I believe the evolution of the Eurobond market and the swap market has been an important development. The Eurobond market has helped develop long term sources of funds at low cost for many currencies such as Lira, New Zealand dollars and Australian dollars that simply didn't exist before. It has enabled U.S. companies to raise dollar funding at lower rates than they could obtain in the U.S. Furthermore, the massive amount of debt issued by U.S. companies in the Eurobond market has obviously aided the U.S. economy by not competing with the issuance of the large level of government debt required to finance our federal deficit.

The swap market has provided significant benefits as well. Swaps allow parties to use their own relative advantage in one market to aid them in another. If I have the greatest advantage in the U.S. short-term market, I can pass this benefit to another party in exchange for, perhaps, their more efficient access to long term markets.

Overall, I do not see any major risk in internationalization. I believe the more intertwined our financial interests, the more likely it is we will coordinate our economic policies. Along these same lines, I would like to say that international capital flows thus far have had a major impact on the value of the dollar and in satisfying this country's need for capital. I believe it is of the utmost importance that our domestic economic policies take into account the interests of these investors. If we mismanage our economy to the point that investors lose confidence in the attractiveness of U.S. investments, we run a great risk of paralleling the experience of many Latin American countries and potentially losing access to valuable worldwide sources of capital.

I would be happy to answer any questions you may have.

Statement of

Peter D. Houchin

Vice President and Deputy Treasurer

PepsiCo, Inc.

Mr. Chairman and Members of the Committee:

The following statement is submitted for the record of the Senate Committee on Banking, Finance and Urban Affairs hearings on the internationalization of capital markets. I am responsible for financing at PepsiCo, Inc., a Fortune 50 multinational corporation and have been involved with both domestic and international capital market transactions for a period of some years. I hope that our views and experiences in these areas will further the Committee's understanding of the extent to which our laws and regulations affect the fashion in which U.S. corporations operate in world capital markets.

The Post-World-War-II wave of direct foreign investment, followed by the growth of multinational businesses and increased sophistication of international markets, is one of the major phenomena of this century. The United States led this trend as a result of our dominant position in the world economy. However, in recent years, as the economies of major industrial countries became more interdependent, we have seen the more developed foreign markets relax their government controls and begin to a great extent to model their trading practices and procedures after our own. Consequently, our laws dictate not only the extent to which American companies may effectively access world capital markets, but also impact increasingly the standards that govern foreign markets.

While the trend toward deregulation in our markets has enhanced American institutions' ability to operate in the international capital forum, further improvement is necessary if we are to successfully compete for world capital resources. Some specific issues that have come to our attention in this regard will be mentioned later.

First, however, I'd like to provide an account of the extent to which PepsiCo has accessed world capital markets. PepsiCo has a long history of growth as a truly international company. Our products are currently found in more than 150 countries, and foreign sales comprise 12% of total revenues. Despite the modest percentage of our sales and profits derived from international business, PepsiCo is an extremely well-known name in almost all countries, perhaps principally because of its consumer marketing, but subsequently because of its performance as a growth company. This fact, combined with the development of global communications and the increased sophistication of international investors, has provided PepsiCo a greater number of opportunities to use the international capital markets to our advantage in meeting the Company's business financing needs.

Our overall financing strategy is built around both securing the lowest attainable cost of funds at any point in time as required to meet the investment opportunities of our business and developing a solid investor base for all types of our securities. Taken together, this approach should provide a desirable long-term cost of capital and improved flexibility. We feel that to achieve these objectives, PepsiCo must constantly assess different markets' trends as well as emerging situations that could constitute market opportunities--the economic outlook and yield curves of world markets, investor sentiment, new structures, alternative currencies and the tax treatment of various securities' structures in different jurisdictions.

This proactive style has resulted in several instances when we have been able to achieve very attractive financing through identification of specific investor needs and innovative structuring. PepsiCo's financing activity in the international capital markets began in 1970 when the Company was the first American Corporate issuer of Eurodollar floating rate notes. PepsiCo Capital Corporation N.V., a subsidiary located in the Netherlands Antilles issued $75 Million in floating rate notes with a term of ten years. This issue was targeted to the European investor who was eager for alternative investments to bank deposits and CD's. For our part, the transaction was an attractive source of funds compared to the then high cost of bank lending, which at the time was typically "Prime" based.

Our next international issue, of SwFr 60MM launched by PepsiCo Capital Corporation N.V. in 1973, was targeted at the Swiss domestic market where yields on fixed income securities were low (6 1/4%) and the differential between Dollar and Swiss Franc costs was large enough to compensate for the potential appreciation of the Franc over time. At the time, 60MM SwFr was a relatively large issue in Switzerland. This has subsequently changed as issues of over SwFr 200MM are now routine indicating the extent to which the market has grown and the acceptability of foreign names has improved.

As the international capital markets developed their trading, distribution and placement functions, through American expertise and capital--as well as from European Bank's growing participation and acceptance of the market--the Euro markets became a preferred route for our financing activities. PepsiCo's growth record and name with foreign portfolio managers and institutions provided a benefit not accorded us in the domestic markets, which are perhaps more conscious of the strict interpretation of the ratings ladder. Even as a single A, Pepsi was able to sell its securities at yields very close to those accorded AAA names. This has continued to be the case over time and is preciously guarded in our dealings with all the international markets. Despite criticism of a number of market participants, the infamous Belgian Dentist is no less astute than his Chicago colleague. We do not trade on name alone but expend

The CHAIRMAN. I'd like to invite panel 2 to come forward, John Hopkins, managing director, Merrill Lynch Mortgage Capital, Merrill Lynch Capital Markets; Daniel P. Kearney, managing director, Salomon Brothers, Inc.; and Charles W. Taylor, chief lending officer, Home Federal Savings & Loan Association.

Mr. Hopkins, if you would like to begin, please.

STATEMENT OF JOHN HOPKINS, MANAGING DIRECTOR, MERRILL LYNCH MORTGAGE CAPITAL, MERRILL LYNCH CAPITAL MARKETS

Mr. HOPKINS. Mr. Chairman, members of the staff, it's a pleasure to be with you this morning. We appreciate the opportunity to air our views on the internationalization of the mortgage capital markets.

By way of introduction, I'm managing director at Merrill Lynch Mortgage Capital and I'm responsible for mortgage-backed secured structured financings at Merrill Lynch.

INCREASED ACTIVITY IN PAST 2 YEARS

In the past 2 years there has been an incredible increase in the amount of activity in the international markets, primarily in the Eurobond markets, and their utilization for raising capital for savings and loans, savings banks, thrifts, as well as a number of the Federal agencies related to the mortgage market.

The primary investors have been in the Eurobond markets banks, insurance companies, pension funds, and in the Japanese market life insurance companies as well as some of the leasing companies.

The Europeans were first into the market. Increasingly we see the Japanese participating in this market. Most of these securities or the vast majority of these securities are debt securities. They are primarily fixed rate, though there's been a significant amount of floating rate debt issued in the Euromarkets, denominated mostly in Eurodollars. There was a recent transaction that was done in Swiss banks with a swap back into dollars.

The issuers have included Fannie Mae, Freddie Mac, a large number of savings and loan associations and savings banks, as well as U.S. mutual life insurance companies, and various property developers.

All of these financings, with the exception of Fannie Mae—and I should mention in late 1984 an issue for the Federal Home Loan Bank Board that was done in the Eurobond market, but with those exceptions, these transactions have been primarily collateralized by various types of mortgages and mortgage-backed securities.

For the savings and loan and savings banks industry these transactions have been collateralized primarily with residential whole loans—that is, unsecuretized mortgages on domestic residential property in the United States, as well as various types of mortgage-backed securities, including Ginnie Mae's, Freddie Mac's PC's, and Fannie Mae mortgage-backed securities.

The mutual life insurance companies have accessed this market using primarily commercial real estate as collateral. That is a relatively new development. It has provided a significant source of funding to mutual life insurance companies.

We have also seen increases in developmental types of financing. That is, financings issued in the Eurobond markets to finance single buildings in the United States. This has been a relatively new device.

The development of these markets and the utilization of these markets stems from the type of security that's being offered, its relative safety, and its quality. Mortgage-backed securities are collateralized by residential mortgages typically but also commercial mortgages. They are typically structured in a way to provide a triple A rating. The loss experience on a mortgage portfolio is typically very small. It provides good security in and of itself. When those securities are packaged with an agency guarantee, they become even more secure and their backing and use as collateral for these types of funding mechanisms—financings overseas—provides typically a triple A rating and a very predictable cash-flow.

TWO TYPES OF TRANSACTIONS

The two types of structures that are typically used are either a market value bond which simply is a bond that is typically in the 7-year area and it's a medium-term financing used in the Eurobond markets, that has as its collateral a portfolio of mortgages or mortgage-backed securities which collateral's value significantly exceeds the amount of the financing.

There are various guidelines from the rating agencies as to the amount of overcollateralization necessary to maintain a triple A rating and typically the borrowers covenant that they will maintain a proper amount of collateral, sometimes in excess of 200 percent of the borrowings depending upon the type of collateral, necessary to maintain a triple A rating and a debt is fixed rate with a term typically of 7 years.

The other type of transaction that is increasingly being utilized in the Eurobond and in the Japanese market is the collateralized mortgage obligation. The collateralized mortgage obligation relies on the cash-flow of the underlying collateral to support the debt payments of the bonds that are issued. It has a bit more volatility relating to the actual maturity date of a particular triage or class of the security and has proven to be a little bit more difficult for the European and Japanese investors to accept; that is, not knowing a date certain for the final payment of their principal investment. But we have seen an increasing utilization of these types of transactions in those markets and increasing acceptance.

Merrill Lynch is obviously a major factor in the domestic and international capital markets. We have very large offices in London and Tokyo that facilitate our access into these markets. Our Tokyo office is celebrating its 25th year in existence. I think that may be the longest of any United States domestic financial brokerage house in Japan or in Tokyo particularly.

Approximately 10 to 15 percent of our new issue business in mortgage-backed securities last year went to the Eurobond and through the Eurobond market and investors in Japan and I would expect that that will probably be 25 percent this year and growing.

As deregulation moves through the international financial community and advantages in communication technology increases in community technology will allow for a greater transfer of both knowledge and information to both issuers and investors. Combine that with the yield advantage that mortgage-backed securities typically offer and the safety that they offer, I would expect that these types of instruments will become a growing share of the international capital market transactions.

Thank you very much, Mr. Chairman.

[The complete prepared statement follows:]

considerable effort to cultivate investor understanding and familiarity with our company, as well as target and manage our placements to ensure appropriate pricing and reception. There have been very few occasions of severe adverse market conditions when a 'Pepsi' issue lacked support and resulted in displeasure among investors.

This halo effect, together with speed and ease of documentation, resulted in our marked preference for the international markets and led to several issues being placed abroad in 1979, 1981, 1982, 1985 and 1986. These issues, including a convertible issue "bought" by CSFB in 1981 reflected the innovation spawned by competing financial institutions and our ability and willingness to act quickly to take advantage of emerging trends. Over the last 10 years, with the exception of municipal bonds, PepsiCo has issued fixed income securities 16 times for a total of $1.5 billion. Of these, fourteen (or $1.2 billion) were in the international markets.

Recently, over the last 2-3 years, as deregulation has been effected in a greater number of markets, the choice of products and financing options has expanded exponentially. As a result, PepsiCo has branched out from traditional fixed rate US Dollar transactions to several foreign currency markets--Swiss, German, Australian, Canadian--and to new products like zero-coupon securities and swap products. These have enabled us to realize often substantial savings compared to comparable domestic sourced

alternatives. Therefore, even though 'shelf' rules domestically have lessened the amount of documentation and improved timing for individual issues, innovation and differing investor preferences still provide as an incentive to target the international markets.

In making our approaches to these markets we have used a broad array of intermediaries as lead managers and co-managers of our issues. Among the market participants, competition is fierce, and as a result, the profit potential for underwriters is limited. Seldom do co-managers of an issue, unless very fully priced, make a respectable profit. In this environment it is easy for a company to obtain competitive quotes for virtually any product, but the execution and subsequent marketability (acceptability to the investor) is key to success of future issues and, as a result, care must be excercised in selection of a management group. Preference is given to those institutions which have known placing capability with the particular product or currency and importantly are prepared to put capital at risk to ensure the issues success. Our banking group for international transactions typically will include our major domestic investment banking relationships, as well as a select group of strong international banks and a few subsidiaries of US commercial banks which have developed expertise in this field. With one or two notable exceptions, we find US commercial banks subsidiaries lacking in placing power and desire to risk capital in support of a transaction, and have therefore tended to rely on major US investment banks' subsidiaries and/or large European (and more recently Japanese) banks for issue management.

As a borrower we have found the international markets to be very flexible in adapting to trends and new ideas. From a cost perspective, there is little to choose between domestic and international environments. While quoted fees are higher internationally, the all-in cost may be comparably higher or lower on any given day. It is the speed and market sentiment which can make the difference. This sentiment can prove positive or, at times, negative. For example, the European market sentiment is more obviously affected by actual or perceived value of the US Dollar compared to other currencies than is the domestic market. So, when the dollar is weak the market for dollar bonds is usually very weak. This sentiment can create gluts and famines and, if a corporation has a continuous need for a high volume of new money, may cause disruptions in financing programs. This has fortunately not been a major concern for PepsiCo and the benefits continue to outweigh the occasional negatives.

In concert with our foreign bond issues PepsiCo has simultaneously listed its stock in Amsterdam, Zurich and Geneva. We have approximately 1% (or $80MM) of our equity held by overseas shareholders. This year, subsequent to recent relaxation of regulations in Japan, we plan to list in Tokyo. We believe that listing our stock on foreign exchanges (provided the

cost is reasonable) not only promotes interest in the Company but also enhances the Company's image in the marketplace as being aware of investor preferences in different markets. More recently, we have increased our efforts to promote equity interest by overseas holders. This reflects our interest in diversification of our investor base as mentioned, and also a realization that overseas investors tend to be longer term holders and less reactive to short-term trends. This adds stability to an increasing "quarter-by-quarter" mentality of domestic institutional managers.

You have requested a view on whether US middle market companies will increase their participation in the international market place. The answer, in my opinion, is yes in the short-term but probably not longer-term if deregulation of the domestic market is allowed to continue. So-called middle market companies are typically those which by definition are relatively small and less sophisticated. This can impact financing in a number of ways. First, in the domestic environment they are ranked compared to the entire US market in terms of credit worthiness and therefore pay higher premiums for funds than might be expected in the international markets where investors are used to a greater number of smaller names. Second, competition for their business is neither as fierce nor as reliable (from the prospective of the financial intermediary it requires a longer view, more administration and often limited 'full-relationship' potential due to geographical controls). On the other hand, I believe European and Japanese commercial banks have made substantial inroads into this market as a result of their greater orientation to long-term relationships, and the international capital markets will, I believe, accept smaller names provided credibility is establised through appropriate sell-in by a prestigious bank. This acceptance is not regardless of the rating accorded the company in the US but it does appear that the domestic markets are less willing to look beyond ratings than are international investors with a currently more narrow choice of investment alternatives. Continued deregulation of the domestic banking market on the other hand, will create improved competition and could therefore lead to lower financing costs for all market participants over time.

The Euromarket particularly has prompted unrivaled innovation over the past few years. Such creativity has certainly been a key attraction for PepsiCo and we believe will be a primary reason for its overall success both with companies the calibre of PepsiCo and others which are less well known and of lesser size. New ideas and greater competition have opened fresh opportunities for lowering the cost of capital. This trend appears to have encouraged the quickening pace of deregulation. However, the markets still have a way to go. Distribution of securities is improving, but to a great extent the retail placement side is still dominated by a limited number of players (eg. the Swiss). This has a tendency to create volatility since those competing firms who do not have true placing power have to

either risk capital or turn to the broker market to take them out of their positions. As mentioned earlier, this may not affect the borrower on a single issue but does create risk to the rest of the underwriting group. As a result, few if any firms are making an adequate return on capital, and over time this must change.

From a US borrower's perspective there continue to be regulatory annoyances which limit the market potential and often they are borne of lack of comprehension that these markets are truly "free". One example of such seemingly unnecessary, and certainly disfunctional regulation, is that impacting our sales of short-term notes internationally. PepsiCo began a Euro-commercial paper program in January this year as a new way to broaden its investor base. In order for PepsiCo to offer short-term bearer notes free from 30% withholding and 20% back-up withholding taxes, the notes must be sold in minimum denominations of at least $500,000 and for periods of less than 183 days. Not only does this restrict maturity flexibility, but more importantly, it completely eliminates the small institution and retail market. Also, we can issue up to 183 day paper and paper with a maturity of over 1 year but no maturities in between (!). While we appreciate that these limitations may be well intentioned (in assuring that the bearer paper came to rest abroad not subject to back-up withholding, the disclosures of which are impossible to sell to international investors), we are sure that the objective could be achieved in a manner less prohibitive to U.S. issuers.

In summary, PepsiCo among many other U.S. corporations continues to enjoy the advantages of innovation, competition, ease of access and price advantage afforded by the development and deregulation of the international capital markets. We do not believe there are incremental risks to investors or borrowers compared to the U.S. domestic markets but feel that over time an even less volatile environment will prevail allowing greater growth. As suggested, there are areas of improvement to be had both internationally, through further easing of current constraints on tax rules and the access of U.S. individuals to these markets as investors, as well as domestically, through streamlining the registration processes and increasing competition by further deregulation of state banking laws and suspension of limitations on participants in the underwriting business. The latter changes are evolutionary and should be handled cautiously to ensure that risk taking and capital adequacy are in balance, since as we have learned from the European experience, this is not necessarily profitable business for newcomers and may impair capital at a time when our U.S. banking system is sorely in need of strength.

I appreciate having an opportunity to express our points of view on this subject and particularly we are pleased to learn of your committee's continuing interest in the impact of these markets on U.S. corprations.

UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS

Testimony by
John J. Hopkins
Managing Director
Merrill Lynch Mortgage Capital, Inc.

February 27, 1986
Dirksen Senate Office Building
Room 538

MERRILL LYNCH CAPITAL MARKETS

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1. How has the mortgage finance market become more international?

In the past two years there has been an increasing interest in mortgage related securities by international investors, particularly the Europeans and the Japanese. These debt instruments have been both fixed and floating rate securities and have nearly all been denominated in U.S. dollars. While foreign investors have enjoyed the return that mortgage backed securities provide, they have not been receptive to the risk that borrowers will prepay their mortgage loans, therefore returning the investor's principal sooner than expected. We have, therefore, seen mortgage lenders issuing more term debt collateralized by mortgages or mortgaged-backed securities than the actual sale of mortgaged-backed securities with their attendant prepayment risks.

Since early 1984, when the Alaska Housing Finance Corporation issued $100 million of Eurobonds collateralized by Federal National Mortgage Association ("FNMA") certificates, a number of issuers of mortgage backed securities have accessed the Eurodollar bond market on a collateralized basis. The first issues to appear took the form of straight fixed-rate notes and bonds. Later, floating-rate notes appeared followed by zero-coupon bonds. More recently, convertible bonds have been offered including some on a collateralized basis.

Collateral for all the early issues took the form of U.S. Government agency securities, including fully-modified pass-through mortgage-backed

The CHAIRMAN. Thank you, Mr. Hopkins.

Mr. Kearney.

STATEMENT OF DANIEL P. KEARNEY, MANAGING DIRECTOR, SALOMON BROS., INC.

Mr. KEARNEY. Thank you, Mr. Chairman. It's a pleasure again to be before this committee. The last time I appeared was 10 years ago when I was president of Ginnie Mae. I am now a managing director and a senior member, mortgage finance and real estate finance departments at Salomon Bros. in New York.

FIXED-RATE MORTGAGES

I think it's fair to say that since 1974 we've had a revolution not only in the capital markets in general but, as the Senator well knows from his close relationship with Dick Pratt and others, the mortgage markets in particular, and it was not too long ago when we were wondering whether there would be a fixed-rate mortgage left in this country and I think it's fair to say that the capital markets have been one of the instrumental factors in preserving the fixed-rate mortgages.

The CHAIRMAN. I just have to say that I told everybody so several years ago.

Mr. KEARNEY. I know you did, Senator, at Park City.

The CHAIRMAN. I said that there will be fixed-rate mortgages again. Nobody believed me. Once in a while it's nice to be able to say I told you so and be right.

Mr. KEARNEY. Well, you were absolutely right.

The CHAIRMAN. I won't tell you about all the time I've been wrong.

Mr. KEARNEY. There's now over 400 billion dollars' worth of mortgage securities outstanding which is equal to the corporate bond market in this country and, as John alluded, I think that the expectation is that we will overtake the corporate bond market and soon be, with the help of Gramm-Rudman, overtaking perhaps the Government bond market in the near future.

While this was happening, the international capital markets were exploding. As John alluded to, the deregulation, the floating exchange rates, all made corporate borrowers able to move wherever money was the cheapest.

It wasn't really until about 2 years ago that we were able to access the international markets for the mortgage securities vehicles. Up until then, the international investor was very name conscious and was obviously receptive to Pepsico and General Motors and names that they well understood from their consumer products, and First Federal Savings & Loan of Phoenix was something that was foreign to most international investors.

It wasn't until that time that we were able to really convince them of the safety and soundness of mortgage securities due to the use of the collateral, as John alluded to, and, of course, the repeal of the withholding act really gave us tremendous impetus in that market.

So truly today, with respect to the mortgage markets, we have a domestic and international market and I think the savings and loans in this country have been able to access the floating rate note market in Europe for over 2 billion dollars' worth of securities in the last year still represents a tremendously good value for European investors versus their alternative instruments and for domestic savings and loans, I might add, presents a very good arbitrage versus their adjustable rate mortgage portfolio.

Against the 11th district cost of funds, for example, the floating rate note gives a 200-basis point pickup for an average savings and loan in California. So we have seen that happen.

GROWTH IN APARTMENT FINANCING

I guess the most important thing from our standpoint that's happened in the last year is in the nonresidential area or the nonsingle family area. First, was the Freddie Mac multifamily participation certificate which did exceedingly well in Europe and which we believe would have even greater receptivity if another issue were to be done today, and the other was the commercial real estate bonds that were first issued last year. And we are planning on a major expansion in that aspect of the market.

One of the real advantages to Europe for American property investors such as Fisher Brothers, Olympia & York and others who have accessed that market is that Europeans are indeed familiar with U.S. real estate from their heavy investment in that in the 1970's and because of the ability to secure the appropriate high ratings from Standard & Poors which last year issued for the first time a rating process for office buildings.

They are in the process of developing similar criteria for apartment buildings and it is expected that that will be out this year and that soon thereafter there will be a rating process for shopping centers. So that American property developers will be able to get ratings on their properties that are in the United States in the shopping center, apartment building and office building category.

We did over 3 billion dollars' worth of those kinds of securities, commercial mortgage securities, in the past year in Europe and Japan and, as I said earlier, we do expect an even larger growth in that market especially due to the Japanese in the next year or 2.

A couple of points we think that are important trends in the internationalization of the market is that the Euromarkets are increasingly becoming institutional and less retail which of course Merrill Lynch and others have been very successful at developing. The smaller investor was the dominant force in the marketplace just as he was here for a long time. As institutional investors, especially the large Japanese institutional investors, come to the United States dollar market we expect mortgage-backed securities to have a very prominent role in their portfolio.

The Japanese investors in particular are important because they are long-term investors and are willing to invest for 30 or as long as 40 years. I believe yesterday a 40-year deal with Fannie Mae was done with a lot of Japanese investors.

As new products have been introduced in the marketplace, the European investor has been much more willing to accept innovation than he had heretofor. As I think John implied, the European investor was until fairly recently a plain vanilla type of investor and didn't want to listen to all the bells and whistles that we had developed for the domestic mortgage market. That's going by the boards and I think that augers well for particularly the commercial aspects of the mortgage market.

Third, and probably this is the most important, the international investment banking market is becoming competitive. London's big bang will occur soon and as a result there will be more risk taking, which is what's happened in the U.S. markets as deregulation, rule 415 and the like have been enacted. We're going to see that kind of thing occurring in the international markets which will make for better pricing for issuers and for investors.

I think we're going to become more proficient in the techniques of currency swaps and interest rate swaps that the previous panel discussed with competing products and with the ability to replicate the kind of issue that was done recently by Glendale where a Swiss franc offering was swapped back in dollars.

We do think that there are some issues that remain. For example, the Ginnie Mae securities are still not a widely accepted vehicle in Europe. Partly that's due to the administrative inconveniences that we all lived through from the beginning of Ginnie Mae with the monthly payment of principal and interest and what's interest and what's principal, et cetera, but in part we believe it has to do with the regulations that the Treasury promulgated in support of the repeal which basically prevents any mortgage that is originated prior to July 1984 from being included in a Ginnie Mae pool and as a result one mortgage would taint the whole pool and therefore European investors are not buying Ginnie Mae securities. That is not a problem with Freddie Mac or Fannie Mae securities.

In general, I would just reiterate that we expect the international markets to play a very heavy role, perhaps even larger than generally expected, up in the order of 50 percent in the next year both in the commercial and single family residential mortgage securities. Thank you.

[The complete prepared statement follows:]

certificates guaranteed by the Government National Mortgage Association ("GNMA"), guaranteed mortgage participation certificates issued by the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and guaranteed mortgage pass-through certificates issued by FNMA, as well as U.S. Government securities and cash.[1] In 1984, however, after the Temporary Regulations repealing U.S. withholding tax on portfolio interest were promulgated, a number of savings & loan transactions were collateralized by more than 51% of "whole mortgage loans" thereby obviating the need to issue in "targeted registered form". Targeted registered form is disadvantageous given traditional retail Eurobond investors' preference for the total anonymity of bearer securities.

Recently, one S&L (Glendale Federal Savings & Loan) issued collateralized securities denominated in Swiss francs.

Freddie Mac introduced two new structures in Europe last year, both of which had previously been well accepted in the U.S. domestic market. On September 27, 1985, Freddie Mac issued the first mortgage pass-through securities in the Euromarket in the form of multifamily participation certificates. This $100,143,618 offering was guaranteed as to timely payment of interest and ultimate collection of principal by Freddie Mac. The transaction was successful and was followed in November by Freddie Mac's issue of the first collateralized mortgage obligations (CMOs) to be offered in the Euromarket.

Freddie Mac specially targeted two classes aggregating ($350,000,000) of eight classes ($1,041,225,000) of Collateralized Mortgage Obligation ("CMO") bonds to European and Japanese investors.

Since December 1984, when a subsidiary of Prudential Insurance Company launched a Eurobond issue to finance part of its commercial mortgage portfolio (though not collateralized by the mortgages), several U.S. insurance companies (especially mutual life companies) issued, through special purpose finance subsidiaries, multi-tranche Eurodollar bonds collateralized by commercial mortgages. These issues were segmented into tranches with different final maturities and irregular sinking funds designed to match as closely as possible the duration of the portfolio being financed. In addition, this structure allows an issuer in a upward sloping yield curve environment to take advantage of the lower rates afforded by pricing part of the financing off the lower yielding earlier part of Treasury securities yield curve. These features make these transactions the forerunners of true CMOs in the Euromarket. The only difference is that different tranches (or classes) can be paid off simultaneously and are amortized according to a pre-set schedule. Prepayments on the underlying mortgages cannot accelerate the repayment of the bonds.

Financings based on the security provided by a single building as collateral have been completed in Europe since the second half of last year for American Express, Middletown Trust, Olympia and York, Fisher Brothers and Equitable.

2. **What has been the role of your institution in this trend?**

Merrill Lynch Capital Markets has been a major force in the international capital markets acting as a manager of various issues utilizing many of the aforementioned structures.

3. **Does the market primarily involve loans, stocks, and/or bonds?**

To date most transactions have involved bonds, although there have been a few bonds convertible into stock. The bonds have been both fixed and variable rate and backed by mortgage collateral held by a trustee. There have also been a small number of syndicated loans and revolving underwriting facilities.

4. **Has your participation been in the Euromarkets or domestic markets?**

Merrill Lynch places a majority of its mortgage related securities with investors in the United States. However, European banks (with the exception of the Swiss who dislike certifying that their clients are not Americans) and Japanese investors are buying increasing amounts of mortgage securities.

5. **Why has there been a trend to use international markets rather than U.S. markets?**

The trend has not been "rather than the U.S. markets" since domestic markets have been growing and continue to grow at a rapid rate. International markets are used because they offer access to an additional discreet group of investors.

6. **What are the risks and benefits associated with internationalization?**

We perceive no serious risks associated with internationalization. The benefits of an international market include 1) an additional source of funds for investment in mortgage securities, 2) a source of funds which can be less expensive from time to time, and 3) an alternative source of funding when the U.S. market becomes temporarily "closed" to certain types of issues.

7. **How difficult is it to participate in the international markets?**

It is no more difficult to do business internationally than it is domestically. However, selling registered obligations that are "targeted to foreign markets" under U.S. Treasury Department regulations is cumbersome because it requires certification by all purchasers that the securities are not beneficially owned by U.S. citizens.

International investors have not developed some of the sophisticated analytics necessary to be major participants in mortgage markets yet. However, as international investor's sophistication grows, so too will their demand for mortgage instruments.

8. **What types of institutions have resorted to the international mortgage finance market? Who are the principal financial intermediaries?**

Savings and loan associations and savings banks are the major issuers of Euro financings. Also participating are issuers such as FNMA and Freddie Mac. The Federal Home Loan Bank has done one Eurodollar bond issue in late 1984. Insurance companies and property developers have also utilized the international markets.

At this time the principal financial intermediaries are U.S. and foreign investment banks.

9. **Do you think U.S. middle market companies will increasingly resort to the international mortgage finance markets?**

Yes, and we expect that as the level of capital market sophistication increases among middle market companies there will be greater utilization of international markets.

10. **Do you foresee even greater participation in international markets in the future?**

Yes, although more education is required of both domestic issuers and international investors.

Statement of Daniel P. Kearney
Managing Director
Salomon Brothers Inc
New York, New York

Before the
Senate Committee on
Banking, Housing and Urban Affairs
On the Subject of Internationalization of
the Mortgage Capital Markets

February 27, 1986

Introduction

Mr. Chairman and Members of the Committee on Banking, Housing and Urban Affairs, my name is Daniel P. Kearney, and I am a Managing Director of Salomon Brothers Inc and a senior member of the Mortgage Finance Department which encompasses all of our activities in the underwriting and issuing of mortgage-related securities. I am also significantly involved in the firm's Real Estate Finance Department. I appreciate the opportunity to testify before the Committee this morning on the internationalization of the mortgage securities market.

Domestic Mortgage Market

It is not an exaggeration to suggest that a virtual revolution has occurred in the domestic mortgage market in the last 15 years. A few years ago, there was a real question whether large numbers of American homebuyers would continue to have the option of a reasonably priced, long-term fixed-rate home mortgage.

By packaging large numbers of individual mortgage loans into mortgage pools, and issuing securities backed by those loans, secondary mortgage market participants like Salomon Brothers have succeeded in creating an efficient and attractive way for the capital markets to provide mortgage money to the American homebuying public.

The percentage of home mortgage loans that are being securitized has grown from only 1 or 2 percent of loan originations in 1970, to almost 40 percent in 1985. In many cases it is only the ability to securitize and sell a mortgage to investors in the secondary market that enables a neighborhood mortgage lender to make an individual loan commitment at a reasonable interest rate.

Mortgage securitization is performing a critical business function in bringing together long term fixed rate investors and mortgage borrowers. Because of its success in providing a better match of the needs of lenders and borrowers, the secondary mortgage market has experienced phenomenal growth over the last 15 years. In 1970, there were less than $1 billion of outstanding publicly-issued mortgage backed securities. By the end of 1985, there were almost $300 billion of such securities outstanding, a market almost as large as the $477 billion of outstanding publicly-issued corporate bonds.

International Capital Markets

During this period of revolution in the domestic mortgage market, the international capital markets have also undergone profound changes.

THE PRIMARY MARKET FOR INTERNATIONAL FIXED-INCOME SECURITIES SURPASSED $165 BILLION LAST YEAR, AN INCREASE OF OVER 120% IN THE PREVIOUS TWO YEARS. U.S. CORPORATE BORROWERS RELY HEAVILY ON ACCESS TO THE EURO-MARKET AND SEVERAL TRULY GLOBAL ISSUES - OFFERED SIMULTANEOUSLY IN EUROPE AND THE UNITED STATES - HAVE BEEN SOLD. BORROWERS, WHO ARE ALWAYS LOOKING FOR THE LOWEST COST OF FUNDS, WILL CONTINUE TO BRING INNOVATION AND STRUCTURAL CHANGE TO THE INTERNATIONAL MARKETS DURING THE COMING YEARS.

INTERNATIONAL MORTGAGE FINANCE

AGAINST THIS BACKDROP - THE REVOLUTION OF THE DOMESTIC MORTGAGE MARKET AND THE EXPLOSION OF INTERNATIONAL FINANCING ACTIVITY - IT IS ONLY NATURAL THAT MORTGAGE SECURITIES SHOULD ENTER THE INTERNATIONAL FINANCIAL MARKETS.

ALTHOUGH THE RECEPTION OF THESE SECURITIES HAS BEEN STRONG, FOREIGN INVESTORS ARE ABOUT WHERE U.S. INSTITUTIONS WERE IN THE LATE '70'S. LET ME DISCUSS BRIEFLY SOME OF THE MAJOR DEVELOPMENTS I HAVE WITNESSED IN THE LAST YEAR AND MAKE SOME PROJECTIONS ABOUT THE MARKET'S DIRECTION.

THERE WERE TWO MAJOR DEVELOPMENTS THAT ENCOURAGED FOREIGN INVESTORS TO EXPAND THEIR PARTICIPATION IN THE MORTGAGE-BACKED SECURITIES MARKET. ONE WAS THE FINAL CLARIFICATION OF WITHHOLDING TAX RULES. THE SECOND WAS THE INTRODUCTION OF A WIDE ARRAY OF NEW PRODUCTS THAT COULD OFFER GREATER APPEAL TO A BROAD BASE OF INSTITUTIONAL INVESTORS.

WHILE THE LAW REPEALING THE 30 PERCENT WITHHOLDING TAX ON NEWLY ORIGINATED SECURITIES FOR FOREIGN INVESTORS WAS SIGNED BY PRESIDENT REAGAN IN JULY 1984, IT WASN'T UNTIL LAST YEAR THAT A CLARIFICATION CAME THROUGH INDICATING THAT THE REPEAL WOULD ALSO APPLY TO INTEREST ON THE DEBT OF INDIVIDUALS. ALMOST IMMEDIATELY, EUROPEAN INVESTORS, WHO PREVIOUSLY WERE SUBJECT TO WITHHOLDING TAXES, BEGAN TO CONSIDER AND PURCHASE MORTGAGE PASS THROUGHS.

ON THE PRODUCT FRONT, WE WITNESSED SEVERAL INNOVATIONS IN 1985 THAT ADDED DEPTH TO THE MARKET WHILE EXPANDING THE AVAILABLE INVESTMENT ALTERNATIVES.

LIBOR FLOATING RATE NOTES

ONE SUCH PRODUCT WAS THE LIBOR BASED FLOATING RATE NOTE (FRN). SINCE NOVEMBER 1984, 14 U.S. THRIFT INSTITUTIONS HAVE ISSUED OVER $2 BILLION OF EURODOLLAR FRNS COLLATERALIZED BY A COMBINATION OF U.S. GOVERNMENT SECURITIES, MORTGAGE SECURITIES AND MORTGAGE LOANS. THE FRNS PROVIDE THRIFTS WITH A SOURCE OF FUNDS THAT IS PERIODICALLY RESET AT A SPECIFIC SPREAD ABOVE A LIBOR INDEX. THE NOTES ARE ALL RATED "AAA" BASED ON THE OVERCOLLATERALIZATION BY MORTGAGES AND SECURITIES. THE ISSUER MUST MAINTAIN THE MARKET VALUE OF THE COLLATERAL AT 140% - 200% OF

The CHAIRMAN. Mr. Taylor.

STATEMENT OF CHARLES W. TAYLOR, CHIEF LENDING OFFICER, HOME FEDERAL SAVINGS & LOAN ASSOCIATION

Mr. TAYLOR. Mr. Chairman, members of the staff, my name is Charles Taylor. I'm first vice president and chief lending officer of Home Federal Savings & Loan Association out of San Diego. We're one of the 10 largest savings and loans in the United States. I appreciate the opportunity to speak to you for a few moments this morning.

BASICALLY FIVE QUESTIONS

It's going to be a little bit of a unique story since ours is different, I think, than you will hear from others, basically I'm going to address five questions. Everything I say in the next 5 or 10 minutes could be fit into those five questions: Why did Home Federal establish an international presence? Where in the world environment could Home Federal expect to establish a client base? How could we deliver our real estate knowledge to that client base? What real estate products do we offer to an offshore investor and why would an offshore investor choose Home Federal as a financial institution?

Why Home Federal established an international presence, obviously was to raise capital for ourselves, something the other two gentlemen were addressing. It's really the domain of our chief financial officer and I'm the chief lending officer, but we basically listed on the London Stock Exchange, I think, more for image and prestige rather than raising equity through that vehicle. We wanted to get our name out in the marketplace and we are one of the few S&L's that have listed there.

We've also put together a commercial paper backup line for issuance of paper in the United States but all the backup is supported by offshore banks, be it Australia, Japan, the United Kingdom, France, Germany, or Switzerland.

The second area we went in to raise capital was really to raise capital for our developers and that's what I'm going to talk to you about this morning.

My background is in international banking. I came into Home Federal 3 years ago under the banking deregulation process that, Mr. Chairman, you're so heavily involved in. My primary reason for joining was to set up a commercial banking function. So what I'm talking to you about is really a different product than I originally went in to work with. I have set up the banking function by the way.

The last 2 years with my previous employer, which was a large international bank, non-United States, we did some work with Asian clients in their investment in the United States and I had worked with these clients and had spent time out there talking to them about their investment needs.

We were marginally successful in meeting their needs or their interests in the real estate area as we did not really have the inhouse expertise nor did we have the real estate products to satisfy those client needs.

Upon coming to Home Federal to establish the banking process, I found a vast reservoir of real estate knowledge which I knew we could have certainly used in my previous employment. Obviously I also found a large number of real estate developers who are certainly interested in more equity for their projects. And by the way, more equity in the projects makes for more secure loans which I think we would all like to see in the S&L business today.

So basically I talked to our senior management about how I felt we could deliver this real estate knowledge to the international marketplace, convinced them that it was something we should try and we decided we would go ahead. Obviously a major question was how could we bridge the gap of being a S&L entering the international marketplace. Although being one of the 10 largest in the United States and one of the most well-capitalized, we still had the problem of getting our name into the marketplace and attracting a client base.

Where in the world environment could Home Federal attempt to establish that client base? I'll tell you at the outset we were looking for individual clients, not institutional clients and that dictates where you're going to start to look for a client base.

We looked at Europe and we felt that it was so heavily institutionalized in terms of capital flows that we did not feel that was the market we would try to approach.

We looked at the Middle East and while we felt it was not as heavily institutionalized we felt there was still sufficient funds flowing through the European financial institutions and that coupled with the fact that my knowledge of the Middle East was more limited compared to other parts of the world, we chose not to look for equity sources there.

We are, though, at the moment putting together a joint venture with a Saudi Arabian group to attract capital from that marketplace, but it's something that we're only looking at after having been in this environment for about 1½ years.

LOOKED TO ASIA FOR INVESTORS

So in 1984 when we started our attempt to develop equity for our developers we looked to Asia. We did not target Japan, again because of the heavily institutionalized nature of Japan and some of the investment restrictions that the Japanese institutions operate under. So we targeted Southeast Asia. We targeted Southeast Asia because it was a place I knew well but more importantly we felt that the investment flows were more fragmented and they were not controlled by the institutional marketplace. They were controlled more by the individuals and we felt we could reach directly to those individuals. So we established an office in Hong Kong, Hong Kong being the financial center of that particular part of the world.

How are we going to go about delivering this real estate knowledge to the Southeast Asian marketplace? We opened a representative office in Hong Kong. We felt we had to have local presence to attract the type of client we wanted. We also felt we had to have local presence to know the market the way we should know it, know who we were doing business with, get to know the legal people, the accounting people, et cetera in those marketplaces to establish the necessary contacts.

We recruited an individual, a British national, who had real estate, commercial banking, and merchant banking experience. He had worked with Richard Ellis, the well known United Kingdom real estate group. He had worked with Bank of America and Citibank in the United Kingdom and in Hong Kong and he was presently at that time employed by Samuel Montague, the British Merchant Bank.

While at Citibank he had experience in the U.S. real estate market through the real estate investment trust [REIT] and we felt this was the type of person who could best represent us in the market.

We also recruited a local Hong Kong Chinese who was U.S. educated at University of Southern California and had lived in the United States for 12 years and had returned to Hong Kong to work with both Citibank and the Hong Kong-Shanghai Banking Corp.

While at Citibank he had been in the private banking group so he obviously had contacts with individual clients.

The Hong Kong office targets individual clients from Taiwan, Thailand, Malaysia, Singapore, Indonesia, and the Philippines. Our targeted individual clients, to be someone we wish to work with, has to be interested in investing a minimum of $1 million of equity capital in any particular project.

What real estate products do we really offer this investor? We assist in identifying products primarily by our developer client base. The product could be apartment buildings, shopping centers, industrial parks, research and development centers. The typical size of the product would require capital, debt and equity of $5 million to $30 million. From this description you can tell we are not in the high-rise office building market. We deal in smaller projects.

The second product we offer is economic valuation. We will value or attempt to place a value on any particular real estate investment that one of our clients is making, basically through the appraisal process.

The third most important product we offer is debt capital, a lending function. We are actively involved as both the construction lender and a permanent lender here in the United States.

The major reason the offshore borrower is attractive to Home Federal is the amount of equity that they bring to a project. Again, more equity, the more solid the project, and we see that as a valuable way to identify quality assets for our particular institution.

I will stress that all our loans are made in the United States and they are made against U.S. products. They are made against first trust deeds strictly. We make no loans outside the United States.

The final product that we do offer is a joint venture where we actually share equity with the offshore investor and we only do this in certain instances, but it is extremely interesting to an offshore client to have someone like ourselves as a partner.

Why would Home Federal be the institution that one of these investors would choose? I think it becomes obvious when you look at some of the things I've just said. As a S&L, real estate is our primary product as opposed to a bank which is much more of a supermarket. The banks are also offering many of the same real estate

THE VALUE OF THE OUTSTANDING FRNS (INCLUDING PRINCIPAL AND ACCRUED INTEREST), DEPENDING ON THE LIQUIDITY CHARACTERISTICS OF THE COLLATERAL AND HOW OFTEN THE COLLATERAL IS VALUED. IF THE THRIFT DEFAULTS ON THE FRN, THE TRUSTEE MUST LIQUIDATE THE COLLATERAL AND REDEEM THE BONDS.

THRIFTS HAVE ISSUED COLLATERALIZED FRNS, FOR MANY REASONS:

- TO DIVERSIFY FUNDING SOURCES;
- TO ACCESS LOW COST FUNDING BY ISSUING HIGHLY RATED DEBT;
- TO LOCK IN ARBITRAGE OPPORTUNITIES ARISING OUT OF THE SPREAD BETWEEN THE THRIFT'S LIBOR-BASED COST OF FUNDS ON THE FRN AND ASSET YIELDS ON ITS ADJUSTABLE-RATE MORTGAGES. RECENTLY, A [illegible] BASIS POINT SPREAD EXISTED BETWEEN THREE-MONTH LIBOR AND THE MOST PREVALENT ONE-YEAR ADJUSTABLE RATE MORTGAGE (ARM) PRODUCT;
- TO TRANSFORM THE FLOATING RATE OBLIGATION INTO A LOW COST, FIXED RATE OBLIGATIONS THROUGH AN INTEREST RATE SWAP; AND
- TO LIQUIFY OLDER, LOWER-COUPON MORTGAGES WITHOUT SELLING THE MORTGAGES AND RECORDING THE RESULTING LOSS. THIS PERMITS THRIFTS TO RESTRUCTURE THE BALANCE SHEET AND IMPROVE THE INTEREST RATE SENSITIVITY POSITION, AND EXTEND THE MATURITY OF THE LIABILITY STRUCTURE.

INVESTOR DEMAND FOR COLLATERALIZED THRIFT FRNS HAS NOT BEEN AS STRONG AS I HAD INITIALLY EXPECTED. THE COMPLEXITY OF THE TRANSACTIONS MAY HAVE DISCOURAGED SOME POTENTIAL PURCHASERS WHO HAVE HAD DIFFICULTY FULLY

UNDERSTANDING THE STRUCTURE OF THESE ISSUES. IN ADDITION, THE HIGHLY PUBLICIZED PROBLEMS OF THE THRIFT INDUSTRY IN GENERAL HAVE CAUSED POTENTIAL BUYERS CONSIDERABLE CONCERN AND HAVE CONTRIBUTED TO THE WARINESS REGARDING ANY THRIFT PAPER. THESE CAUTIOUS TRADING PATTERNS ARE NOT JUSTIFIED FROM THE PERSPECTIVE OF CREDIT RISK BECAUSE THE COLLATERALIZED THRIFT FRN STRUCTURE OFFERS A SECURE INVESTMENT VEHICLE.

FREDDIE MAC ISSUANCE

TWO OF THE MORE IMPORTANT EUROMARKET MORTGAGE TRANSACTIONS LAST YEAR WERE BROUGHT BY FREDDIE MAC. IN AUGUST, FREDDIE MAC INTRODUCED A NEW MORTGAGE SECURITY -- THE MULTIFAMILY MORTGAGE PARTICIPATION CERTIFICATE. AFTER ISSUING [illegible] MILLION OF THESE SECURITIES DOMESTICALLY, THE AGENCY SOLD AN ADDITIONAL [illegible] MILLION TO EUROPEAN INVESTORS, MARKING THE FIRST TIME AN ENTIRE TRANSACTION OF MULTIFAMILY SECURITIES WAS SOLD INTERNATIONALLY.

SALOMON BROTHERS WORKED WITH FREDDIE MAC IN STRUCTURING THE MORTGAGE PRODUCT AND THE NEW SECURITIES. EUROPEAN INVESTORS WELCOMED THE PASS-THROUGHS BECAUSE THE UNDERLYING MORTGAGES PERMITTED NO PREPAYMENT FOR THE FIRST [illegible] MONTHS. FOR THAT PERIOD, INVESTORS WERE GIVEN ABSOLUTE CALL PROTECTION.

PRIOR TO THE ISSUE, FREDDIE MAC AND MEMBERS OF THE [illegible] SPENT CONSIDERABLE TIME IN THE EUROMARKET HELPING THE UNDERWRITERS AND POTENTIAL INVESTORS UNDERSTAND NOT ONLY THE TRANSACTION BUT WHO THE AGENCY WAS AND THE ROLE IT PLAYED IN FINANCING AMERICAN HOUSING.

That groundwork helped provide a warm welcome for the multifamily PC — especially among some institutions who entered the mortgage market for the first time. Their educational efforts also set the stage for a second innovative financing — a $1 billion, eight-tranche CMO that was simultaneously targeted to investors both here and abroad. This was the first global CMO and it made the most of the more precise tailoring of cash flows that are the trademark of this type of security. The CMO cut financing costs for Freddie Mac while simultaneously providing international investors with the durations and returns that best matched their individual needs. In the case of this offering, offshore investors selected the higher coupon tranches to earn higher current returns. The Japanese were among the active participants.

Commercial Mortgage Backed Bonds

Looking at some of the other significant mortgage transactions in 1985, several insurance companies have improved their asset/liability management and raised cash by bundling portfolios of seasoned commercial mortgages loans and using them to collateralize borrowings in the Euromarkets.

One such transaction was the $1.3 billion issue Salomon Brothers underwrote for Prudential Realty Securities III that closed in January of last year. Still the largest fixed-rate Eurodollar transaction ever done, the Prudential transaction involved applying the proceeds

of the offering to the purchase of a portfolio of commercial mortgages. The cash flow from the mortgages was used to structure the bonds. Investors had confidence in the offering because Prudential Funding, a AAA credit, guaranteed the bonds in the event of a delinquency or default.

In February 1985, Salomon Brothers lead managed for New England Life what was the first public commercial mortgage-backed security, a $300 million issue comprised of two annual-pay fixed-payment bonds and a 14-year zero coupon bond.

Connecticut Mutual, Phoenix Mutual and Mutual Benefit have accessed the Euromarket with similar structures collateralized by the cash flows from high quality commercial loans. In total almost $3 billion of these securities have been sold in the Euromarket in the last 12 months. In all cases, the issuers preferred the Euromarket because they obtained better executions than available to them in the domestic market. The issues continue to trade well in the aftermarket.

Real Estate Backed Mortgages

By year's end, Salomon Brothers broke new ground by offering European investors bonds backed by two multi-tenanted Manhattan office buildings. The bonds, issued by Olympia & York and Fisher Brothers, were rated AA by Standard & Poors based solely on the cash flows from the buildings and limited third party credit support. There was no recourse to either developer.

Earlier in the year, Salomon Brothers and Shearson Lehman Brothers had structured the financing for the new world headquarters of American Express. That transaction included a $450 million zero-coupon Eurobond that had recourse only to the property.

While American Express was the first nonrecourse property-specific financing to be rated by Standard & Poor's, the Olympia & York and Fisher Brothers transactions proved that multipurpose, seasoned office buildings, with tenants of diverse credit, could also have their cash flows evaluated, rated and sold to European investors.

As with the insurance company financings, the high ratings permitted European investors to look at the investment the same way they would any similarly-rated corporate security. Because the security was new, investors were able to earn higher returns with what is in all likelihood much less risk. I was pleased to see global participation in both of these rated offerings and anticipate excellent growth for this area in the coming year.

Constraints on Development

Despite the introduction of these new sophisticated products, the Euromarkets for the mortgage-backed securities continue to function on a very elementary level. Some of the administrative - the so-called "back-office" problems - we witnessed in trading mortgage-backed securities here in the 1970's have developed in Europe. The demand for Ginnie Maes - which offer the yields investors want - has been constrained by some of the administrative concerns in accounting, settling, and trading these securities. In addition, even with the clarification in the withholding tax rules, agency pass-through securities sales are limited to pools whose underlying mortgages were originated after July 1984 - which is only a small percentage of the outstanding securities. Also, the "targeted registered" distribution process has yet to be fully embraced by European investors. But, I believe, the problems will be overcome as technology becomes more sophisticated and there is greater analytical understanding of the products and producers.

Trends in Internationalization

In the time remaining let me point to a few important trends underway that bode well for the development of a strong mortgage-backed securities market overseas and greater participation from a broader range of investors.

First, the Euromarkets are shifting form retail to institutional. A few years ago, the smaller investor was the dominant force in the marketplace. Today it's increasingly institutional - and they are the investors who are best able to understand the mortgage-backed securities market and who have the resources to enter it.

ALSO, JAPANESE INVESTORS ARE BECOMING A MAJOR FORCE IN THIS MARKET AS THEY BECOME MORE AGGRESSIVE BUYERS OF DOLLAR-DENOMINATED SECURITIES. THEIR DEMAND FOR HIGH QUALITY AND HIGH CURRENT YIELD IS SATISFIED BY MORTGAGE INVESTMENTS. THE INVOLVEMENT OF THE JAPANESE IS A MAJOR FACTOR IN THE GLOBALIZATION OF THE MORTGAGE-BACKED SECURITIES MARKET.

SECOND, NEW PRODUCTS INTRODUCED INTO THE MARKETPLACE HAVE, FOR THE MOST PART, RECEIVED A GOOD INITIAL ACCEPTANCE. THERE HAS BEEN CONSIDERABLE AND WELCOME DIVERSITY IN THE MIX OF INSTITUTIONAL INVESTORS ENTERING THE MARKET.

THEIR WILLINGNESS TO EXAMINE NEW PRODUCTS IS ENCOURAGING. GRADUALLY, I THINK WE WILL BE ABLE TO INTEREST THESE INVESTORS IN PRODUCTS THAT HAVE GAINED WIDE ACCEPTANCE IN THIS COUNTRY. FOR EXAMPLE, THE FREDDIE MAC MULTIFAMILY OFFERING TAUGHT ME THAT PASS THROUGHS STAND A GOOD CHANCE OF SUCCESS. FOR THE FIRST TIME EURO-INVESTORS WERE WILLING TO EXPLORE PRODUCTS WITHOUT COMPLETE CALL PROTECTION AND WITH MONTHLY PAYMENT STREAMS. I WOULD NOT BE SURPRISED TO ULTIMATELY SEE OTHER ASSET-BASED FINANCINGS, SUCH AS AUTOMOBILE LOANS, FIND THEIR WAY INTO THE EUROMARKET.

THIRD, INTERNATIONAL INVESTMENT BANKING IS A COMPETITIVE BUSINESS. U.S. COMMERCIAL BANKS, UNABLE TO PARTICIPATE IN THE DOMESTIC MORTGAGE MARKET, ARE EAGER TO EMBRACE THE EUROMARKET. WE RECOGNIZE THAT AS MORE

BANKERS MAKE MARKETS IN MORTGAGE-BACKED SECURITIES ABROAD, SPREADS WILL TIGHTEN, LIQUIDITY WILL IMPROVE, AND MORE EUROPEAN INVESTORS WILL BE ENCOURAGED TO PARTICIPATE.

FOURTH, WE ARE GROWING MORE PROFICIENT WITH TECHNIQUES SUCH AS CURRENCY SWAPS AND INTEREST RATE SWAPS. IN A MARKET WHERE WE WILL BE COMPETING WITH OTHER EURODOLLAR PRODUCTS AND EUROYEN OFFERINGS, WE MUST BE ABLE TO HELP NEW INVESTORS IN MORTGAGE-RELATED PRODUCTS HEDGE INTO CURRENCIES THEY NEED AND MOVE BETWEEN FLOATING AND FIXED RATE PRODUCTS. AS IS THE CASE IN THE UNITED STATES, FUND MANAGERS MAKE ASSET ALLOCATION DECISIONS BASED UPON PERFORMANCE.

WE ALSO HAVE A RESPONSIBILITY TO HELP THEM BY TRACKING THE OVERALL PERFORMANCE OF MORTGAGE SECURITIES, AND WE'RE MEETING THAT OBLIGATION WITH SOPHISTICATED DATABASES, SUCH AS SALOMON BROTHERS' NEW BROAD INVESTMENT-GRADE BOND INDEX, WHICH MONITORS RETURNS ON MORTGAGE-BACKED SECURITIES AND COMPARES THEM WITH THOSE OF OTHER FIXED-INCOME TAXABLE BONDS.

FINALLY, EUROPE IS MOVING RAPIDLY AND DECISIVELY TOWARD DEREGULATION. MORTGAGE FINANCE HAS CHANGED DRAMATICALLY AND THERE IS AN INCREASINGLY GREATER RELIANCE ON WHOLESALE FUNDS, THAT IS, THE CAPITAL MARKETS, FOR FINANCING.

OVERALL, THERE WILL BE GREATER OPPORTUNITY FOR INVESTMENT IN MORTGAGE-BACKED SECURITIES, AS WELL AS STIFFER COMPETITION FROM OTHER INVESTMENT

ALTERNATIVES. HOW WELL MORTGAGE-BACKED SECURITIES FARE IN WHAT IS RAPIDLY BECOMING THE GLOBAL CAPITAL MARKETS WILL DEPEND ON BOTH THE SECURITIES' PERFORMANCE AND HOW WELL INVESTORS UNDERSTAND THEM. WITH ONLY A ABOUT A QUARTER OF THE U.S. RESIDENTIAL MORTGAGE MARKET SECURITIZED, THE DOMESTIC MARKET IS STILL DESTINED FOR CONTINUED EXPANSION. BUT, SIMULTANEOUSLY, I BELIEVE, MORTGAGE-BACKED SECURITIES WILL DEMONSTRATE DRAMATIC GROWTH IN THE EUROMARKETS AND IN JAPAN.

THE INTERNATIONAL DEVELOPMENT OF A MORTGAGE-BACKED SECURITIES MARKET MAY MEAN A SLIGHTLY MORE COMPETITIVE WORLD FOR ALL INVESTORS WHO WILL BE BIDDING FOR PRODUCTS WITH THE BEST CREDIT AND YIELD. BUT IN THE LONG-RUN, AS OUR DOMESTIC EXPERIENCE HAS SHOWN, THE HOMEBUYER WILL BENEFIT MOST FROM THE CONTINUED EXPANSION OF THIS MARKET.

THE OVERSEAS GROWTH WE'VE WITNESSED SO FAR INDICATES THAT WHAT BEGAN AS THE RESIDENTIAL MORTGAGE MARKET IS MOVING A LONG WAY FROM HOME.

products we offer but they don't concentrate on it to the extent that we do. The banks make construction loans. We make construction loans. But we also make permanent loans. So we offer a broader lending base to the offshore client.

When an investor talks to one of our developers about a project we actually tell the investor what amount of money we're going to lend on a project, again getting into the economic valuation process. When generally dealing with a bank or a broker an investor does not have that type of advantage.

Finally, as I said a second ago, when an investor can have someone like ourselves as a joint venture partner his or her investor confidence becomes a lot greater, presumably the chances for success are a lot greater, and it becomes a nice package to offer.

Thank you for the opportunity to talk to you.

[The complete prepared statement follows:]

Statement of
Charles W. Taylor
First Vice President and Chief Lending Officer
Home Federal Savings and Loan Association
San Diego, California

Mr. Chairman, members of the Committee, my name is Charles W. Taylor and I am First Vice President and Senior Lending Officer of Home Federal Savings and Loan in San Diego, California. I appreciate the opportunity to appear here today to address the internationalization of capital markets, and, more specifically, how Home Federal is approaching these markets.

Home Federal is quite active in international capital markets. Our stock is traded on the London Stock Exchange. However, it is about our lending activities in Asia on which I will focus my remarks today.

When Home Federal Savings and Loan Association in San Diego opened an international investments office in Hong Kong in April 1985, it became the first S&L to open an Asian office. I will discuss in detail why we felt the strengths of our institution in California could meet the needs of the market in Asia.

Hong Kong may well be the key Asian market for U.S. real estate services. An office in Hong Kong greatly enhances a thrift's marketing capabilities to that country and beyond. Initially, Home Federal will market directly to the areas offering the greatest opportunities: Hong Kong, Southeast Asia and Japan. In partnership with foreign investors, we

believe we can serve Californians' interests as well as foreign interests, making it a happy marriage with our Pacific Basin neighbors.

Home Federal—A Profile

Home Federal has 157 offices throughout the state of California, and has significant involvement in financing major real estate transactions ($1 million or more). Last year, major loans accounted for over $2 billion in new assets for Home Federal. Major loan activity is concentrated in California, where five major loan offices cover the state, and in the Sunbelt states through offices in Florida, Atlanta, and Washington, D.C.

In 1972, Home Federal established a wholly owned subsidiary, Home Capital Corporation, to invest equity in residential land development projects. Today, Home Capital is one of the largest and most active S&L subsidiaries engaged in this activity. Home Capital has substantial land holdings in Southern California which it is developing. Through Home Capital, Home Federal is able to take equity positions in real estate investments.

Home Federal's management has consistently been praised by financial analysts and the industry. Three times in recent years Home Federal was aksed by federal regulators to manage major savings and loans which were declared insolvent.

In 1983 Home Federal converted from a mutual charter to a public stock company. In June 1984 Home Federal's shares were listed on the New York

Stock Exchange, and in February 1985 the shares were listed on the London Stock Exchange. Today Home Federal has total assets of over $9 bilion and a net worth of almost $700 billion.

International Investments Department

Home Federal's International Investments Department was formed in 1984. The department was established as a means of providing Home Federal's real estate expertise to foreign investors. The department's strategy is to identify, analyze, structure, and finance the U.S. real estate investments of foreign investors.

In April 1985 Home Federal International-Hong Kong was established. It is the first Asian office ever opened by a U.S. savings and loan. A Hong Kong office enables Home Federal to identify and screen qualified investors and to maintain ongoing contact with them to determine and clarify their investment criteria. An overseas office also permits Home Federal to conduct continuous face-to-face negotiations on specific investments. This is far superior to long distance communications via telephones or telex and enables much speedier deal closings.

In achieving its strategy, the International Investments Department is seeking to develop and promote strong, ongoing relationships between Home Federal, the foreign investor, and U.S. developers and investors. The emphasis is on relationships, not deals.

Influx of Foreign Capital

The infusion of foreign capital into the United States has grown phenomenally. In 1983 more than $100 billion in foreign capital flowed into the country. In 1984 this number grew to $150 billion and is expected to continue to rise.

Although the funds flow into a variety of investments, economists estimate that over the past 10 years, as much as $70 bilion has gone into U.S. real estate. This year, it is expected to increase by another $10 billion.

What is the reason for this large influx of international capital? For a foreign investor, the United States offers an attractive investment climate with the following:

- there is political stability within this country unmatched elsewhere;
- this country welcomes foreign real estate investment with few restrictions and favorable tax treatments;
- our market in California offers a large, strong, diversified and growing economic base;
- there has been historic appreciation of real estate investments with an attractive rate of return vis-a-vis many foreign real estate opportunities; and,
- long-term financing is available at reasonable rates.

Targeted Foreign Borrowers

Interestingly enough, there is no single international market for U.S. real estate investments. There are many. The typical investor varies by continent and country, ranging from European or Japanese insurance companies seeking all-cash investments of $50 million and up, to Southeast Asian individuals seeking $1 million purchases.

Home Federal made the decision to approach individual investors as opposed to institutional investors. Europe is heavily dominated by institutional investors and we decided not to start there.

While the Middle East is not as heavily institutionalized in capital flows as Europe, significant quantities of funds do flow through European institutions, coupled with relatively fewer business contacts there, led us not to start there either. However, I will add that we are forming a joint venture with a Saudi group to act as a conduit for Middle Eastern investment in U.S. real estate.

Thus, in 1984, when we started our program we began with a marketing effort aimed at Asian clients. We did not target Japan, as, again, it is dominated by institutional funds. We focused on Southeast Asia because the investor market is fragmented from the institutional investment perspective and we believed that with our contacts we could reach directly to the individual investor. As Hong Kong is the financial center of that region, we decided to establish our presence there.

With long-established family businesses as diverse as coconut plantations and dress manufacturing, Asian investors have sizable amounts of capital for investing. Yet, however rich in capital these nations may be, they are not equally as rich in investment opportunities. From an investment standpoint, for example, the Asian real estate market is slow at the moment. Even manufacturing, once a robust investment opportunity in some Southeast Asian countries, is flat, having peaked and now leveled off. Hence, investors are forced to look elsewhere for a good return on their dollar, so they look to America.

West Coast real estate lenders such as Home Federal, then, are in a unique position to share their real estate expertise with Asian investors. The West Coast is not only more familiar to Asian investors, but it enjoys a growing healthy economic and real estate base.

Meeting Financial Needs of Foreign Investors and Goals of Home Federal

With a history of real estate lending and active involvement in real estate development in California, thrifts there may be in a strong position to match the needs of foreign investors with quality real estate products and financing. Unlike its major competitors in this arena--specifically the large commercial banks--Home Federal, a $9 billion savings institution, views it role not as a broker with the primary goal of moving properties and producing fee income, but rather as a long-term real estate lender. This long-term relationship and commitment from a lender appeals to foreign investors, especially those who previously made investments and were left without a banker's ongoing support once the transaction was completed.

Some of the real estate services demanded by Asian investors are the identification of properties for sale, the analysis of the property, the structuring of the investment and financing of the U.S. real estate. Oftentimes, Asian investors will already hold properties. A lender can structure debt packages which enhance the return on investment. With a legal lending limit on secured real estate transactions of more than $500 million, Home Federal can meet most financing needs of foreign investors.

High Quality Loans: Home Federal is in business to make real estate loans, and we approach our Asian operation as an effective way of placing high quality loans on our books. The borrowers we find are all well able to meet the debt service on the loans and make significant down payments on their investments, further assuring loan quality. We offer the investor the ability to structure debt packages which enhance the return on investment.

As experienced lenders with a strong knowledge of major markets, we can be very flexible in our debt terms. We offer short-, medium- and long-term financing with a variety of pricing options. While we generally price on a floating rate basis, we do have some fixed-rate capabilities.

Service to Developers: Furthermore, we can provide a valuable service to our customers that are developers. The search for investment properties is typically driven by the specific needs of the investor. For developers, Asian investment represents a valuable source of equity. Many of the developers with whom Home Federal has established relationships in the past are sources of investment opportunities ranging from construction projects

to fully built and leased properties.

Fee Income: A real estate services company earns profits principally through loan fees and interest. Home Federal expects to realize more than $1 million in gross revenue from business generated by the Hong Kong office during its first year of operation. To date, those international marketing activities have generated more than $60 million in new loans, a joint venture and consulting fees.

Services for Investors

Analyzing Investments: Upon receipt of a complete package from the property owner, Home Federal analyzes the information to ensure that it is an accurate and fair representation. Rents, expenses, cap rates, and other assumptions are verified to ensure they are in line with current market conditions. The property is analyzed with respect to location, its tenants and their leases, any existing financing which may be assumable, and any other factors which may affect the property's value. During this, we also determine the property's attractiveness as security for a real estate loan. It is Home Federal's policy that any property offered to an investor must be one against which we are willing to lend. As a result of this process, over 90 percent of the properties which we are offered are rejected during this initial screening. Also during this time we establish a preliminary opinion of value--a price which is believed to reflect an approximate market value.

After this process, properties are analyzed with respect to their suitability for specific investors. Frequent discussions are held with investors. Our objective is to define precisely what the investor seeks so that any properties presented have a high probability of being accepted.

Structuring Investments: The investment objectives of investors determine the structure the investment should take. These objectives, in turn, are determined by many things, including the investor's liquidity, ability to use tax-loss benefits, return objectives, and aptitude for risk. The same property investment can be structured in a number of different ways to achieve different objectives.

For example, an investment in an office building can be structured as:

- All-cash purchase
- Leveraged purchase
- Joint venture
- Limited partnership
- Participating debt
- Conventional debt with or without purchase option
- Convertible mortgage
- Participating certificates of deposit

Even with the above choices, combinations and variations are possible.

Further complicating matters, for each type of investment, a different investment vehicle (California, Netherlands Antilles, Dutch, etc. corporation) is frequently required to minimize U.S. tax liabilities or to achieve other objectives.

Mr. Chairman, I thank you for the opportunity to appear before you today, and I would be happy to answer any questions you or members of the Committee might have.

The CHAIRMAN. Thank you, Mr. Taylor.

Mr. Kearney, the first question I have for you is are you going to come to Park City again this year?

Mr. KEARNEY. Yes, sir. I have my reservations at 4:30 tomorrow afternoon.

The CHAIRMAN. You'd better do some snow dances then.

Mr. KEARNEY. Is it bad out there?

The CHAIRMAN. The tulips are coming out and, unfortunately, we have had a very good ski season—it was great at Christmas time, but the last few days it's been over 70 degrees in Salt Lake City.

Mr. KEARNEY. I'll get to spend a lot of time on the program then.

The CHAIRMAN. I wish I could switch it to bring the 70 degree temperature back here and keep it snowing out there. First of all, we know how to handle snow and drive on it. We don't close schools a day for each inch of snow. In my whole life in public schools in Utah I never got a snow day. It didn't matter whether it was 2 or 3 feet. But here somebody spits on the sidewalk and everything comes to a screeching halt. I'll be there too, but hopefully we'll have some new fresh snow by the time we both get there.

Mr. KEARNEY. I look forward to that.

The CHAIRMAN. But we need your money to be spent whether there's snow or not so bring a lot with you.

INTERNATIONAL MORTGAGE-BACKED SECURITIES MARKET

You mentioned in your testimony, Mr. Kearney, that participation of commercial banks in the international mortgage-backed securities market will tighten spreads, improve liquidity, and encourage more investors to participate.

Wouldn't the same thing be true if U.S. commercial banks were allowed to participate in the U.S. mortgage-backed securities markets?

Mr. KEARNEY. Well, I think that the banks have a greater history of participation in the Euromarkets in general and that is what's made them competitive there. Domestically—I know John has some background in the municipal area—I'm not really qualified to discuss what the banks have been able to do domestically, but certainly they are formidable competition in the international markets.

The CHAIRMAN. Of course, they haven't been able to offer them. That was the subject of my bill that passed the Senate 89 to 5 that did allow mortgage-backed securities as well as municipal revenue bonds.

Mr. KEARNEY. Well, I think one of the things that has made the domestic mortgage-backed securities market as important as it has been in the past 5 years has been the ability to trade and distribute mortgage-backed securities. That's why Salomon, Morgan Stanley, Merrill Lynch, and others have been as successful as they have at it. I think that the banks have not generally had that kind of experience and the international markets until fairly recently have not been heavily weighted toward distribution and risk taking.

That's changing in line with what's happening domestically here.

The CHAIRMAN. Mr. Taylor, you're living proof of something else I also said a few years ago and that was when we got involved with the limited commercial nature of savings and loans. All the critics were saying that savings and loans don't have the ability to manage a variety of investments, that isn't their area of expertise. And I also made the comment from this same chair that they would be smart enough to hire commercial bankers to run those departments, which has happened.

Mr. TAYLOR. Yes, it certainly has.

The CHAIRMAN. All of the S&L's that have really gone into those new powers to any extent recognized their limitations in that particular field and did hire people such as you who had experience in commercial banking.

Mr. TAYLOR. Without exception, I agree.

The CHAIRMAN. Given the explosive growth which is occurring in mortgage-backed securities markets, both domestically and internationally, and the need for thrifts to avoid borrowing short and lending long, what is your view of the proposed qualified thrift lender test which as you know requires a thrift to retain mortgages in their own portfolio? Does it make sense in today's world, let alone tomorrow's, to have a qualified thrift lender test?

Mr. TAYLOR. Well, to be honest with you, Mr. Chairman, that's an area that I really have spent little time in. Remember, I came out of commercial banking 3 years ago and I was only made chief lending officer about 5 weeks ago, so I'm just really getting into some of those questions and I don't think my opinion would be of real value.

The CHAIRMAN. Well, what I'm driving at is this. Everyone agrees that the securitization of long-term fixed-rate mortgages and the efforts to develop the secondary market to make more mortgage money available to drive interest rates down is a good thing. Yet we say to the thrifts, "You've got to retain those fixed-rate mortgages in your portfolio." That was the very thing that got the thrifts in such bad trouble in 1982.

Mr. TAYLOR. Right.

The CHAIRMAN. Borrowing short and lending long and getting stuck with a lot of 5, 6, 7, 8, 9 percent mortgages with 15 percent and finally up to 21 percent prime interest rates. Yet what we're saying—at least some are saying—is that we should have this qualified thrift lender test and force you to keep x percentage of your mortgages in-house. It seems to me the trends are conflicting.

Mr. TAYLOR. I would agree with that and I guess basically I don't think it's a good idea, but I'm not an expert in that area.

MARKET GROWING BY LEAPS AND BOUNDS

The CHAIRMAN. Either Mr. Kearney or Mr. Hopkins or both, yesterday's Wall Street Journal reported that First Boston and Salomon Bros. together handle about 60 to 70 percent of mortgage trading, that Merrill Lynch is the third largest trader. The article also reported the volume of trading has become so large that some firms are currently unable to handle all the business and the market is expected to grow by leaps and bounds.

Is this true? Is the Wall Street Journal telling us the truth about what's going to happen?

Mr. Kearney. I certainly wouldn't want to dispute Dow Jones I don't think.

Mr. Hopkins. I think the market is going to grow in leaps and bounds, Senator. That's about the only thing I care to comment on. I think that there has been a dramatic growth in the number of transactions related to mortgage-backed securities; that is, trades. The nature of mortgage-backed securities, given that they prepay—that there are different dollar flows changing monthly, that pools and what constitutes good delivery of securities makes them a good deal more difficult to handle and the fact that Ginnie Mae's are still physical—that is, there is a piece of paper that's delivered once a month this all takes place—complicates the back office procedures of the various firms involved in trading these securities.

However, I think most of the major firms, with one notable—notable only in the sense that they've gone public are the exception—are able to handle these transactions and have the capacity to on a timely and accurate basis process the trading volume that is currently taking place.

One of the things obviously that impacts this is the dramatic move in the fixed-income markets in terms of interest rates. When you have a move as large as we've had over the last 3 or 4 months that impacts the trading volume immensely in the securities. There's a great deal of profit taking going on; that is, investors who held these securities through the lean times now may have profits and are taking their profits. Also, you had yearend occur at the same time as a strong rally in the fixed-income markets. Therefore, there was an increased opportunity to take profit—there was an opportunity to take profit in a yearend statement date coming up so the volume of securities traded in December and also in January were records, significantly above normal trading. I guess Merrill Lynch—in 1984 we were probably settling—that is, trades bought and sold in the mortgage area—about $8 billion a month. In December last year we settled approximately $20 billion that month of mortgage-backed securities.

The Chairman. How much additional trading is generated by international markets?

Mr. Hopkins. There is not a great deal of trading in the international markets. The types of securities that we have sold overseas are primarily of the fixed-rate nature and some of the floating rate bonds that we've done that are collateralized with mortgages. These tend to go away. That is, they're bought by institutional investors for portfolio investment and they do not come out in trade. There is not an extremely active trading market in mortgage-backed securities away from the types of transactions that we put into that marketplace in Europe or Japan.

What I'm referring to are the mortgage-backed securities like Ginnie Mae and Fannie Mae mortgage-backed securities and Freddie Mac PC's which pay monthly and amortize principal monthly and have these prepayments. That is the primary trading volume in this country. It's not overseas because they don't hold those types of securities.

The Chairman. Senator Sasser.

Senator Sasser. Thank you, Mr. Chairman.

$70 BILLION FOREIGN MONEY INVESTED IN U.S. REAL ESTATE

Mr. Taylor, in your statement, you indicate that over the past 10 years as much as $70 billion has gone into U.S. real estate from foreign investors and it's expected to increase by another $10 billion this year.

What type of real estate investments are these foreign investors primarily in? Is it localized principally on the west coast or is it spread uniformly across the country?

Mr. TAYLOR. I'd say geographically there's tremendous interest in California. There's a certain degree of interest in Arizona. There has been a lot of interest in Texas in the past, unfortunate for many of them at this present time. There's interest in the Southeast and in the Northeast I'd say primarily. You might find some in the Midwest or the heartland, but I would say those areas.

As far as what it goes into, it really covers a wide range. Many will go into single-family residences and condominiums, et cetera. The very wealthy, as we all hear, have bought office buildings and so forth, but the type of person we're interested in would be more inclined to go into an apartment building, a shopping center, maybe a small industrial park, where the total capital—debt and equity—anywhere from $5 to $15 million would be the general type.

Senator SASSER. You indicate in your statement that for these investors from abroad there are a number of things that make a real estate investment in the United States an attractive investment. One of the things that's mentioned is long-term financing available at reasonable rates.

Now we have a competition for capital to some extent in this country, with our Federal deficit absorbing a very substantial amount of capital. Some indicate that last year the Federal deficit absorbed the equivalent of about 60 percent of the domestic capital available for lending, if we had financed it all at home. I think when all the counting is done we'll find that about half of the Federal deficit was financed with capital from abroad and about half of that, or about 25 percent of the Federal deficit, was financed with capital from Japan.

But my question is, are we creating a competition for capital here in allowing foreign investors to come here and invest in our real estate, with one of the inducements being long-term financing at reasonable rates?

Mr. TAYLOR. I think two quick parts to the answer, Senator. One, as far as long-term rates that are at attractive pricing, et cetera, that's really directed toward what type of long-term financing is available in other marketplaces, that is Singapore, Hong Kong, et cetera. And the type of 10, 12, 15 year money that's available in the United States is certainly much cheaper than is generally available, if it's even ever available, in any of those markets. So I think that's part of the answer.

More importantly, the heart, excess competition for available sources of capital, my answer would be definitely no. I would go back, as mentioned by somebody here this morning—I wrote my thesis on the subject back in 1967—one of the big topics was the Eurobond market and were U.S. corporations absorbing excess amounts of capital on the Eurobond market, and certainly from looking back to 1967, the amount of capital that was available for the Eurobond market far exceeded any needs that U.S. corporations had. The same analogy would hold true today I think. There's so much capital available, the amount that any foreign investment group can aggregately take is so small that it's not—it would be hard to find in the aggregate I think.

Senator SASSER. Do the rest of the members of the panel agree with that assessment? In your judgment, is the use of capital by foreign investors in American real estate not a significant contributor to competition for capital in this country?

Mr. KEARNEY. Only at the margin.

Senator SASSER. Now one ongoing challenge to this committee is to find and support new ways to smooth out the boom or bust cycle in the housing market. I have been in the Senate now for 8 years and I've experienced I think two of those. The housing market is traditionally very sensitive to interest rates. Adjustable rate home mortgages have made a difference. As has been testified here this morning, the secondary market also has made a difference.

What impact does internationalization have on this process of removing housing from the extremes of interest rate fluctuations? Does internationalization help or hurt that process of trying to get out of the boom-or-bust business and stabilize interest rates to some extent?

Mr. KEARNEY. Well, let me say, Senator, I think that it has helped and I think we've had such a remarkable change—Senator Garn mentioned fixed rate mortgages are still in vogue. I think one of the problems for the volatility was that the liability structure of the home mortgage lender was basically short term and the asset structure was long term.

What's happened with sophisticated management such as Home Federal and others is that through the use of interest rate swaps and the availability of both domestic and foreign long-term capital that can be raised by these institutions they've been able to match-fund their longer term mortgages with longer term liabilities. So that's happened on one score.

Another anecdotal evidence of that is over 2 billion dollars' worth of these floating rate notes have been able to be raised in Europe and it's primarily an international market, although there is some domestic floating rate notes, and those have provided a very attractive spread versus the adjustable rate mortgage product that institutions have originated.

So that I would say, on balance, fairly clearly that internationalization has helped to make permanent that transition process that we've seen.

Senator SASSER. Well, do you think internationalization has been a significant factor in stabilization?

Mr. KEARNEY. I think that what's happened with international markets generally—corporate bond markets in general—is that it has made the best execution the only question that an issuer asks, whether it's international or domestic—where can I get the best price? And I think in that sense that has made a difference for the mortgage securities market as well.

Senator SASSER. Thank you, gentlemen.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Sasser.

Mr. Hopkins, has Dick Pratt invited you to Park City?

Mr. **Hopkins**. Yes, he has. I'll be out there tomorrow afternoon I hope. I think I'll do a little praying for snow too.

The **Chairman**. Well, there's snow there. Unfortunately, when it gets that warm so early it melts in the afternoon and freezes at night. It's still better than Eastern snow, even under those conditions. In fact, I had a neighbor of mine out there skiing and he said, "Jake, everything you've always said about Utah snow is true. It's magnificent." I said, "No, it isn't. It isn't up to our normal standards." He said, "Well, compared to where I ski in Pennsylvania, it's magnificent." So we do have to keep it in relative terms. Even when ours is bad, it's better than what they call skiing in the East. I'm sorry, I just have to speak in truth and fact and when I see 600-foot hills with double chairlifts on them I have to smile compared to our 3,000-foot vertical drops and so on. I've got to get a few shots in for the Chamber of Commerce.

Mr. **Hopkins**. We'll be there.

The **Chairman**. Good. Thank you, gentlemen. We appreciate your testimony.

[Whereupon, at 10:55 a.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

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March 21, 1986

Mr. M. Danny Wall
Staff Director
Committee on Banking, Housing &
Urban Affairs
United States Senate
SD-534, Dirksen Building
Washington, D.C. 20510

Re: Internationalization of the Securities Markets

Dear Mr. Wall:

The Senate Committee on Banking, Housing and Urban Affairs has recently conducted hearings on the subject of the Internationalization of the Securities Markets. The North American Securities Administrators Association (NASAA) was unable to testify at these hearings, [redacted]ing [redacted]record [redacted]s since NASAA has been active in and has given a very high priority to its participation in the deliberations concerning one very significant aspect of the internationalization phenomenon.

As you know, NASAA is the organization of securities administrators of the states of the United States, the provinces of Canada, and Puerto Rico and Mexico. NASAA has participated actively on virtually all of the significant federal and state securities issues that have arisen in recent years, and has been frequently represented in testimony before committees of the Senate and the House of Representatives relating to securities matters as well as the oversight and budget of the Securities and Exchange Commission (Commission).

Last year, the Commission issued Release 33-6568, requesting comments on a proposal to facilitate multi-national securities offerings by harmonizing disclosure and distribution practices among countries, initially the United States, Canada and the United Kingdom. Pursuant to that request, NASAA prepared and tendered to the

Commission its comment letter of August 16, 1985, a copy of which is enclosed for your review and for the record.

NASAA supports the objectives of the Commission in attempting to facilitate multi-national securities offerings which are now made difficult by a vast array of differences from country to country in terms of the conditions and requirements of any offering, disclosure standards, distribution practices, litigation and liability exposure and other problems. In our comment, we outlined five majors areas in which the states have particular concern due to the interaction between state securities regulation and regulation on a federal level.

While these concerns are of a material and substantive nature, the sixth issue commented on by NASAA in its comment letter relates to a procedural issue of at least equal importance. This procedural issue is the role that the states will play in connection with the discussions anticipated to take place among representatives of the three countries named above. It is NASAA's view that, in order for the objective of facilitation of such offerings to be realized, it is imperative that the states be adequately represented in the discussions between the Commission and securities regulators of Canada and the United Kingdom. Without such direct participation, there will be no assurance that the consenus reached in those discussions will be effective at a state level, with the consequence that any streamlining of the review process for such offerings at the Commission will not be matched at the state level. The unfortunate result will be that the facilitation objectives will be frustrated.

We note that an analogous problem existed in Canada where the securities regulation jurisdiction is handled on a provincial level rather than at the national government level. In that case, the Canadian securities administrators met to designate two of their number to represent them in discussions with United States and the United Kingdom. In a sense, NASAA plays that same role for state securities administrators.

We have made known NASAA's view on this subject to the Commission and its staff on numerous occasions, most recently at a conference held this month in Washington, D.C. To date, final resolution of this point has not been made, but we expect to press forward. We have also taken the opportunity to establish direct contact with our counterparts in Canada as well as with the United Kingdom through its Embassy in Washington, D.C. We intend to pursue these direct discussions with all parties.

Finally, we believe that NASAA can play a vital role in the educational process with respect to multi-national issues. For example, the existence of a complementary state securities regulatory system in this country is not well known abroad. The Commission has recognized this informational gap and has attempted to fill it by advising foreign counterparts whenever appropriate. However, we believe that this is clearly the direct responsibility of NASAA, and intend to fulfill that responsibility. Accordingly, NASAA has recently authorized a significant delegation to attend the annual conference of the International Association of Securities Commissions and Similar Organizations as a step in pursuing this educational objective.

We appreciate the opportunity to provide the ~~Committee with this information, and stand ready to~~ assist in any way which we can in the work of the Committee and its staff.

Very truly yours,

Franklin Tom

FRANKLIN TOM, Chairman
Committee on Multi-National
Securities Offerings

FT:ad
Enclosure

cc: Mr. Royce Griffin
Mr. Raymond Patton
Mr. Bruce Burditt
Mr. James Rosapepe
Ms. Maureen Thompson

FT NASAA folder

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Copy to Wally Wong
then file multi-
national offering
comm.

August 16, 1985

DEPARTMENT OF CORPORATIONS
RECEIVED
AUG 21 1985
LOS ANGELES OFFICE

Mr. John Wheeler
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

RE: File NO. S7-9-85
SEC Release No. 33-6568

Dear Mr. Wheeler:

The Securities and Exchange Commission has proposed two methods, a "reciprocal approach" and a "common approach" as a means to facilitate multinational securities offerings by harmonizing disclosure and distribution practices among countries. Through SEC Release 33-6568, the Commission has requested comments on these two approaches as they would be applied to the United States, the United Kingdom and Canada.

This letter will attempt to set forth particular state concerns without dwelling extensively on all general disclosure issues.

I. THE ABILITY OF THE STATES TO CONTINUE TO RELY ON THE SEC'S REVIEW AS A BASIS FOR FINDING THAT FULL AND FAIR DISCLOSURE HAS BEEN MADE WILL DEPEND UPON THE ACCOMMODATIONS MADE BY THE SEC IN RECONCILING DIFFERENCES IN DISCLOSURE STANDARDS WITH THE UNITED KINGDOM AND CANADA.

State securities regulation has relied substantially upon the SEC'S review as the basis for finding that full and fair disclosure has been made. While most state securities administrators retain discretion to require additional disclosure, as a matter of practice disclosure satisfactory under the Securities Act of 1933 has been viewed as generally sufficient for state purposes. State reliance upon SEC disclosure standards and review is a recognition of the extensive disclosure requirements of the '33 Act, the current views and practices of the SEC staff and the liability imposed for violation of the '33 Act. A major change in any of these factors as a means of accommodating differing disclosure standards in order to facilitate multinational offerings may require the states, in satisfaction of their obligations under their respective laws, to undertake more extensive review of the quality of disclosure material. This may act to slow review of multinational offerings and make less certain the ultimate disclosure standards which must be met by Canadian and United Kingdom companies. Any proposal to accommodate lesser disclosure standards should be cognizant of the fact that the quality of current SEC disclosure has acted to harmonize and facilitate securities offerings among the States by providing a standard of disclosure acceptable to all.

The SEC's February, 1985 Survey of Disclosure Standards indicates numerous differences between the disclosure requirements of the United States, the United Kingdom and Canada. Canadian companies are often not required to make negative disclosure. United Kingdom companies do not require disclosure of general business developments. Extensive industry guides such as those for oil and gas programs and real estate programs do not existt in the United Kingdom or Canada. The United Kingdom does not require a section regarding management discussion and analysis of financial condition and results of operations. A specific risk factor section is not required in either the United Kingdom or Canada.

With respect to directors and executive officers, the SEC survey reports: "This item appears to be the most affected by different concepts of materiality and privacy. Outside the U.S. individual disclosure of compensation and business experience is thought to be an unwarranted intrusion into a person's privacy. Disclosure focuses on aggregate compensation of all directors as a whole, without naming them with current positions and titles." The SEC survey reveals quite clearly that, in virtually every area of disclosure required under the 33 Act, United Kingdom and Canadian disclosure requirements are never more stringent and in no circumstances appears to be more extensive than that required in the U.S.

II. ANY APPROACH TO FACILITATE MULTINATIONAL OFFERINGS MUST ALLOW EACH STATE AN OPPORTUNITY TO REQUIRE ADDITIONAL DISCLOSURE WHERE THERE ARE: 1) SUBSTANTIVE REQUIREMENTS UNIQUE TO THAT STATE OR, 2) WHERE THE STATES' VIEWS ON MATERIALITY DIFFER FROM THAT OF OTHER JURISDICTIONS.

The disclosure of substantive standards or conditions imposed by a state is best reviewed by the state imposing that standard or condition. In California, for example, a restriction on transfer requiring the consent of the Commissioner of Corporations prior to any transfer of a security can be imposed as a condition of qualification. Review of the adequacy of the disclosure of this limitation is obviously best made by California. To the extent various jurisdictions may differ as a matter of case law or administrative determination as to what is material, each jurisdiction should also retain the ability to require additional disclosure.

For example, until recently, disclosure regarding anti-takeover provisions was not a high priorty item under SEC review. The California Department of Corporations, however, took the view early on that where significant limitations on shareholder democracy were present, at a minimum, disclosure was required.

These differences as to the materiality a disclosure may also arise in the context of the differences in what is generally customary in the various jurisdictions. For example, British Columbia corporations have long been subject to the requirement that certain corporate acts be passed by "special resolution." Such a resolution requires approval by 75% of the shares present and voting at a shareholders' meeting. This type of provision, especially that basing such percentage on the number of shares present and voting, is relatively unusual in the United States. However, disclosure of this requirement of law is normally not made in British Columbia prospectuses.

III. A COMMON OR RECIPROCAL APPROACH WITH RESPECT TO DISCLOSURE DOES NOT RELIEVE AN ISSUER FROM CONFORMING WITH THE SUBSTANTIVE REQUIREMENTS OF EACH STATE IN WHICH THAT ISSUER OFFERS OR SELLS SECURITIES.

It is our understanding that the SEC proposal is limited to reconciling the form and substance of disclosure and underwriting procedure and does not effect the application of state substantive review standards. State substantive review standards are a critical element in maintaining the integrity of the marketplace and must not be diluted.

IV. NON-UNITED STATES DOMICILED ISSUERS MAY BE REQUIRED TO MAKE ADDITIONAL DISCLOSURE REGARDING THE LAWS AND PRACTICES OF THE DOMICILE OF THAT ISSUER.

Similar to the treatment of "special resolutions" as discussed above, the regulatory authorities of the domicile of the issuer may regard information about the laws and practices of that domicile to be matters of common knowledge. However, such information may be new and material to investors in foreign jurisdictions. Accordingly, it may be appropriate to provide specific disclosure regarding laws of the domicile of an issuer for matters such as:

1) Director's liability.

2) Shareholder democracy.

3) Reorganization procedures.

4) Bankruptcy laws.

5) Common law matters such as the "business judgment rule" and "piercing the corporate veil."

6) The extent of any limitations or conditions on the limited liability of the investor.

7) Applicable tax laws.

8) Applicable securities laws.

9) Limitations on foreign ownership.

Disclosure of the nature suggested above is not unusual. For example in the June 4, 1984, prospectus of Reuters Holdings PLC, the following disclosure was made regarding United Kingdom exchange controls: "Such restrictions have been removed, and there are now no foreign exchange control restrictions on remittance of dividends on B shares or on the conduct of Reuters' operations, although legislation is in force pursuant to which exchange controls may be reimposed administratively at any time."

A recent offering by an Irish corporation, the Institute of Clinical Pharmacology Ltd., disclosed that Republic of Ireland tax law operates in the following fashion:

> The Capital Acquisitions Tax Act, 1976, provides for imposition of both a gift tax and an inheritance tax. Although ADS may be held by non-residents, the underlying Ordinary Shares are deemed to be situated in Ireland because IPC is required to maintain its original share register in Ireland. Accordingly, ADS may be subject to Irish gift or inheritance taxes notwithstanding that the donor or descendant is domiciled and resident outside of Ireland. Irish gift taxes are not

> creditable against United States gift taxes, if any, on a gift of ICP stock. Irish inheritance taxes should be creditable, in whole or part, against United States federal estate taxes.

The prospectus of Reuters Holdings PLC also contains the following disclosure:

> Reuters Holdings PLC ("Reuters Holdings") is a public limited company incorporated in England. Most of its directors and officers and the experts named herein are residents of the United Kingdom and other non-United States jurisdictions. All or a substantial portion of the assets of such persons, and all the assets of Reuters Holdings, are located in the United Kingdom and other non-United States jurisdictions. As a result, it may be difficult for investors to effect service within the United States upon such persons or to realize against them in the United States upon judgments of courts of the United States predicated upon civil liabilities under the United States federal securities law.

In view of the substantial differences which may exist between the laws and practices of various countrys, the effect that such laws and practices may have on non-resident investors and the interaction of such laws and practices with the laws of the domicile of non-resident investors, it may be useful to require specific disclosure about laws and practices which affect the issuer. Indeed, to the extent that foreign laws are so material as to impact upon an investor's decision, consideration ought to be given to requiring prominent disclosure.

V. SUBSTANTIAL DISCLOSURE REGARDING DIFFERENCES IN ACCOUNTING PRACTICES AND THEIR EFFECT UPON THE FINANCIAL STATEMENTS OF A FOREIGN ISSUER MUST BE SPECIFICALLY REQUIRED.

Numerous differences exist in the generally accepted accounting principles (GAAP) of the United States, the United Kingdom and Canada. Without debating the merits of the various principles, it is essential that a common practice be adopted or a pro forma restatement of the financial statements of the country in which the prospectus is used be required. The results of the differences in accounting principles can be very significant and since the financial statements of the various countries use the same descriptive terminology in line items, financial statements prepared under the GAAP of a foreign country can be unintentionally misleading. Further, it may not be possible in many instances to recalculate a financial statement according to the GAAP of the domicile of an investor.

Some examples of how differences in GAAP can effect financial statements are contained in an article in the May, 1985 edition of Dun's Business Month, which quoted Larry D. Horner, Chairman and CEO of Peat Marwick, Mitchell & Co. Horner cited as examples the recent public offering of $4 billion dollars of British Telecom plc stock including $280 million offered in the United States. In that offering, Telecom reported according to U.K. GAAP, earnings of $1.2 billion in fiscal 1984. When that figure was adjusted to reflect principally different treatment of deferred taxes under U.S. and Canadian GAAP, earnings were reduced to $697 million. Royal Dutch Shell Group was also cited as an example. Shell Group's 1981 earnings, adjusted on the basis of current cost accounting practices common to the Netherlands, the United Kingdom and the United States, equaled 404 million pounds. Further adjustments to reflect inflation accounting practices in the individual countries produced the following results. Netherlands -- 90 million pounds, United Kingdom -- 70 million pounds and United States -- 1,100 million pounds.

VI. ANY DEVELOPMENT OF DISCLOSURE STANDARDS TO FACILITATE MULTINATIONAL OFFERINGS MUST INCLUDE STATE SECURITIES ADMINISTRATORS PARTICIPATION, THROUGH THE NORTH AMERICAN SECURITIES ADMINISTRATORS' ASSOCIATION.

Development of disclosure standards to facilitate multinational offerings that might alter the current system, requires participation by NASAA for several reasons. First, foreign issuers generally must comply with state regulatory requirements. Hence, changes in disclosure standards which do not take into account such requirements will not necessarily result in facilitating the offering of multinational securities.

Second, to the extent state securities regulation may be looked upon as a "laboratory" in the area of innovative policy development, important issues that might otherwise be overlooked could surface during the process of developing standards.

Third, the inclusion of state securities regulators, i.e. NASAA, in any group developing standards or policies for multinational securities offerings, will significantly ease the process of adoption of federal standards at the state level. The imprimateur of a NASAA resolution endorsing a multi-party effort in this area, will have great influence in obtaining individual state acceptance, thereby furthering the ultimate objective being considered the Commission.

On behalf of NASAA, the undersigned members of NASAA's Committee on Multinational Offerings appreciate the opportunity to provide the Commission with our views. We are available to assist the Commission and staff as this matter progresses.

Very truly yours,

Michael Unger, Chairman
Director
Massachusetts Securities
Division

on behalf of

Rodger Marting
Commissioner
Ohio Division of Securities

Lewis Brothers
Director
Virginia Division of Securities
and Retail Franchising

Franklin Tom
Commissioner
California Department of
Corporations

STATEMENT OF THE
PUBLIC SECURITIES ASSOCIATION
ON THE INTERNATIONALIZATION OF THE CAPITAL MARKETS

The Public Securities Association welcomes this opportunity to submit written comments relating to the Committee on Banking, Housing and Urban Affairs February 26-27, 1986 hearings, on the subject of the internationalization of the capital markets.

The Public Securities Association is the national trade organization of banks, dealers and brokers that underwrite, trade and sell U.S. Government and Federal Agency securities, municipal securities and mortgage backed securities. Our membership includes all thirty-six primary dealers in U.S. Government securities, as recognized by the Federal Reserve Bank of New York, and all major dealers in mortgage backed securities.

PSA is vitally interested in, and intimately involved with, many of the complex issues surrounding the rapid globalization of the securities markets. We believe that the internationalization of the securities markets is not only inevitable, but a very positive development for our domestic capital markets. We believe such internationalization will broaden available funding sources and thus offer access to additional discreet groups of investors throughout the world. Most significantly, from the perspective of debt issuers, including our own Treasury, increasing the supply of funds available for borrowing should tend to lower borrowing costs.

To a great extent, debt and equity markets are already international. Today, approximately 15 percent of the U.S. Treasury's securities are foreign owned. By way of example, in 1981 foreign investment accounted for 8.9 percent of the net increase in U.S. Treasury debt outstanding. It has been estimated that foreign investors will absorb approximately 14 percent of the net increase in Treasury debt in 1986. Overseas trading activity in U.S. Government securities has been estimated to range between $3 billion and $3.5 billion on a daily basis. In addition, Japanese net purchases of non-yen securities (equity and debt) more than doubled to $55 billion from $30 billion in 1984. The dollar portion of these purchases increased to 86 percent in 1985 from 75 percent in 1984.

Moreover, the volume of trading by non-nationals on the New York, London and Tokyo stock exchanges has risen dramatically from 1980 to 1984 -- in New York from $75 billion to $124 billion, in Tokyo from $19 billion to $73 billion, and in London from $9 billion to $17 billion. Also, we should note that during the last three years more than 30 domestic corporations have offered, in aggregate, more than $2.2 billion of equity securities in international markets.

PSA believes that as a matter of sound public policy, the best way to further the development of efficiently functioning, international securities markets is to promote open participation and access to these markets by all financial institutions without regard to their country of origin. A particular financial institution's citizenship should not be used as a criterion in determining whether that institution can participate in a market. PSA has already taken action consistent with this position. On January 17, 1986, PSA adopted a policy position within the context of its own by-laws relating to foreign financial institution membership in PSA. The Board of Directors voted to add a new provision to its statement of objectives which reads as follows:

> The objects and purposes of the Association shall be:
>
> * * * *
>
> (c) To support the goal of open and free access to the public securities markets throughout the world, with participation of multi-national financial institutions not restricted by narrow questioning of nationality.

Each current member of PSA and all new applicants have been notified of the adoption of this new by-law provision. The Board's intention is that every current member and each new applicant of PSA will endorse and actively support this provision. It should be noted that following adoption of this new by-law provision we accepted firms from Japan and Switzerland as new members in the Association. This is in addition to other foreign owned firms from England, Canada and Hong Kong who were already members of PSA. PSA firmly believes that by opening national securities markets to international competition, and by eliminating restrictions on the free flow of capital between countries economic efficiency will be promoted.

PSA's efforts are not restricted to its own by-laws. The Association has also recently announced the formation of a London-Based Primary Dealers Committee. The Committee is composed of the thirty primary dealers in U.S. Government securities along with five inter-dealer brokers which currently conduct business in the U.K. The Committee will become a subcommittee of the Primary Dealers Committee of PSA. The formation of this Committee is PSA's initial effort at formally organizing the primary dealer community on an international basis as the U.S. Government securities market becomes more global in nature. Indeed, trading in U.S. Government securities has become increasingly active in London with an estimated average volume of between $750 million and $2 billion trading daily.

Currently PSA is planning the formation of a Tokyo-Based Primary Dealers Committee, similar in form, structure, and purpose to the London-Based Committee. PSA's interest in establishing a Committee in Japan results from both the increased importance of the Japanese markets during the last five years and its projected growth in the future. Net purchases of foreign bonds by Japanese investors has grown from $950 million in 1980 to $65 billion in 1985. PSA believes that the establishment of a Tokyo-Based Committee, along with the Committee being established in London, will permit the U.S. Government securities dealer community to speak with a unified voice in communicating with the European and Far East governments in not only promoting our interest in free and open access to international capital markets, but other issues of common concern to the marketplace.

PSA sees little serious risk with increased securities internationalization. On the contrary, the benefits are substantial. Common sense suggests that the free flow of capital across international borders is beneficial for both investors and borrowers. In recent years, this country in particular has been a prime beneficiary of such capital flows. Corporations are relying more and more on the public securities markets -- both foreign and domestic -- rather than bank loans as a source of financing. The decreased use of bank loans is a material result of the increasing efficiency of capital markets; due in part to the internationalization of these markets.

As a nation, we have a vast need for capital to support economic growth, develop new industries and produce more jobs. International markets provide an additional source of capital. International markets may also provide less expensive capital from time to time, and may also provide an alternative source of funding when this country's markets face an "oversupply" of certain types of issues. Further improvements in productivity and industrial competitiveness depend, to a very substantial extent, on the capacity of our financial markets to raise large amounts of capital cheaply and to allocate that capital efficiently. For these reasons and others, open and free access to international capital markets is vital.

Over the course of the past several years PSA has worked to promote greater long-term investment in the United States and to improve access to the foreign capital markets by U.S. borrowers, particularly the U.S. Government and the federally sponsored agencies. This group of borrowers also includes the government-related secondary mortgage market agencies, such as the Government National Mortgage Association, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. In this regard, we actively supported the repeal of the 30 percent withholding tax on interest paid to foreign investors. It was PSA's view that repeal of this tax would facilitate borrowing in the foreign capital markets and would enable the U.S. Government and the nation's mortgage credit institutions to diversify their sources of funds. By eliminating the withholding tax, U.S. Government and mortgage backed securities have become more competitive with alternative investments in the Eurodollar bond market. The ability of our financial markets to compete in the international markets and to raise large amounts of capital cheaply, from various sources, is important to our continued economic strength.

Access to some of the overseas financial markets is not as unrestricted as is access to the markets in this country. In Japan, for example, although there are signs of an opening of securities markets to foreign firms, considerable barriers still exist. In order to engage in a full-fledged brokerage business in Japan, it is necessary to obtain authorization from the

Ministry of Finance. This process takes considerable time. And even if a foreign broker-dealer obtains a license from the Ministry of Finance to engage in the brokerage business, the Japanese stock exchanges make membership difficult to obtain. Today three U.S. financial institutions are members of the Tokyo Stock Exchange. On January 6, 1986, the Tokyo Exchange let Merrill Lynch, Morgan Stanley, Goldman Sachs, S.G. Warburg, Jardine Fleming and Vickers da Costa purchase seats. Four foreign applicants did not make the cut: Salomon Brothers, First Boston, Smith Barney and W.I. Carr. Without these seats business in Japan is severely restricted. Foreign firms which have a securities business license to operate as a branch must pay a 23 percent commission to the Japanese broker for his role as an intermediary to the retail client.

In an effort to deregulate its financial markets and permit more foreign competition, the Japanese Ministry of Finance has recently advised three large U.S. banks, the Bank of America, Citibank and Chase Manhattan, that they would be licensed to trade in the secondary market for government bonds. Such authority apparently covers local, regional, as well as national securities. Press reports indicate that other foreign banks may also be authorized to deal in government bonds.

Although there have been some recent pronouncements by the Ministry of Finance which indicate that Japanese banks and securities houses should restrain their purchases of foreign securities, the Ministry just last month approved a new 500 billion yen ($2.5 billion) closed-end unit investment trust. The fund will reportedly invest 50 percent of its assets in foreign bonds, such as long-term U.S. Treasury issues, and 50 percent in Japanese Government Bonds. Four of the leading Japanese financial institutions are managing this trust, including Nomura, Daiwa, Yamaichi and Nikko Securities. Each of these firms has also expressed an interest in seeking to become primary dealers in U.S. Government securities.

Recent developments in Great Britain indicate a willingness to further open its financial markets to foreign securities firms. Underscoring the trend towards liberalization are decisions to abolish fixed commission rates and the dual capacity system, allowing firms to perform both brokerage and dealing activities.

In the fall of 1986 the market for British government securities ("gilts") is scheduled to undergo a revolutionary change. It is being remodeled to resemble the market for United States Government obligations. Market-makers in U.K. Government securities will have to become members of the London Stock Exchange. The Stock Exchange is revising its rules in order to allow foreign institutions to own up to 100 percent of a member firm. Until such change becomes effective on March 31, 1986, foreign firms could acquire only a 29.9 percent stake in firms which are members of the Stock Exchange.

As of June 17, 1985, twenty-nine firms had confirmed to the Bank of England their intention to become primary dealers in

British Government securities. Eleven of these firms are linked to U.S. banks or securities firms. Such American companies are: Citicorp, Bank of America, Bankers Trust, Chase Manhattan, Goldman Sachs, Security Pacific, Merrill Lynch, Shearson Lehman, Morgan Guaranty, Prudential Bache and Salomon Brothers. The Financial Times, June 18, 1985 at 12. No Japanese firm is among the firms approved by the Bank of England: The Financial Times speculates that had Japanese firms applied, they would have been ruled out, in any case, on reciprocity grounds because "the equivalent Tokyo markets remain virtually closed to foreigners." The Bank of England has adopted a policy of reciprocal treatment in regulating foreign financial institutions. For example, the Bank of England does not permit foreign-owned institutions to lead in the distribution of new issues within the sterling capital market unless "in the Bank's view there are reciprocal opportunities" in these foreign capital markets for equivalent UK-owned institutions. The concept of reciprocity also appears in the U.K.'s Financial Services Bill currently pending in the Parliament. This bill will create a comprehensive new regulatory structure for all investment activities taking place in the U.K.

Access to capital markets by foreign financial institutions, where permitted, is regulated according to two standards, reciprocity and national treatment. With reciprocal treatment -- as is the case with the Bank of England described above -- a host nation provides foreign financial institutions with the same regulatory treatment that the foreign firm's home country provides to institutions of the host nation. National treatment allows the host nation to provide foreign financial institutions with the same regulatory treatment that it provides to domestic institutions.

This country has formally adopted a policy of national treatment when it enacted The International Banking Act of 1978. The policy was reiterated by President Reagan on September 9, 1983, when he stated:

> The basic tenet for treatment of investment is the national treatment principle: foreign investors should be treated no less favorably than domestic investors in like situations.

Although Japan, Great Britain and the United States have made significant strides in opening their respective financial and securities markets to foreign institutions, other countries still have a long way to go. Canada and West Germany, as an illustration, prohibit foreign financial institutions from joining the primary distribution syndicate for their government securities. In Canada, changes have been proposed by the Ontario Securities Commission that may result in more liberalized market access by foreign firms. The Ontario Commission's proposals, however, are being opposed by a report of the Ontario Task Force on Financial Institutions. West Germany has provided no indication at all that it is willing to permit foreign financial institutions into the primary selling group for its government securities. At this time, foreign institutions cannot underwrite

Deutschemark denominated securities for any domestic German borrower. National treatment appears quite some time away.

The efforts of PSA and others to promote the development of efficient, orderly, openly competitive and adequately regulated international securities markets involve issues not only of national politics, but also of technology. Technology is making possible the rapid globalization of the markets. Computer linkages are now being established which will insure 24 hour markets in most internationally traded securities. From our perspective, there is already virtual 24 hour over-the-counter trading in U.S. Government securities.

There is also an increasing number of worldwide electronic linkages between existing exchanges. For example, the Boston and Montreal stock exchanges are now electronically linked; the Chicago Mercantile Exchange has established a link with the Singapore International Monetary Exchange; in an arrangement that includes the Options Clearing Corp., the Philadelphia Stock Exchange has announced its link with the London Stock Exchange, targeted for August 30, 1985; the American and Toronto exchanges are contemplating linkage; linkage reportedly is being discussed by the New York and London stock exchanges; the Philadelphia and London Stock Exchanges recently agreed to form what will be, in effect, a single market in British pound options; the Chicago Mercantile Exchange obtained the right to trade futures and options based on two major Japanese stock market averages, the Nikkei 225 and 500; and the

American Stock Exchange is negotiating with Institutional Networks Corp. to form an electronic link allowing Europeans to trade directly in some Amex options products.

Many of the issues discussed herein are currently being examined in a number of other forums. Two world-wide trade bodies, the Organization for Economic Cooperation and Development (OECD) and the international body considering revisions to the General Agreement on Tariffs and Trade (GATT) are studying the internationalization of debt and equity markets. The OECD is seeking comments on a study it is conducting which is being entitled, International Trade in Services: Securities. The United States representatives to the GATT council have made a considerable effort to have international trade in services on the agenda for the GATT meeting in the spring. They are currently gathering data on the issue.

In sum, it is important that the Congress monitor closely developments in the international markets and promote the adoption of statutory and regulatory structures which permit free and open market access to the world's capital markets. The internationalization of financial markets will inject a healthy element of competition in the world economy. The more competition there is, the more efficient financial markets will become, and the better it will be for all participants in what is fast becoming a world economy.

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